TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

November 17, 1981

Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Staff Statements Appended to the Transcript

Mr. Cross, Manager for Foreign Operations
Mr. Sternlight, Manager for Domestic Operations
Mr. Kichline, Economist
Mr. Axilrod, Secretary and Staff Adviser

Meeting of the Federal Open Market Committee

November 17, 1981

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, November 17, 1981, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mr. Keehn
Mr. Partee
Mr. Rice
Mr. Schultz
Mrs. Teeters
Mr. Wallich

Messrs. Balles, Black, Ford, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, 1/ Morris and Roos, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Axilrod, Staff Director
Mr. Altmann, Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel 1/
Mr. Oltman, Deputy General Counsel
Mr. Mannion, Assistant General Counsel
Mr. Kichline, Economist

Messrs. Burns, Ettin, Mullineaux, Prell, Scheld, Truman, and Zeisel, Associate Economists

1/ Left the meeting prior to the action to adopt the domestic policy directive.

Mr. Cross, Manager for Foreign Operations, System Open Market Account

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account

Mr. Coyne, Assistant to the Board of Governors
Messrs. Gemmill and Siegman, Associate Directors, Division of International Finance, Board of Governors
Mr. Lindsey, Assistant Director, Division of Research and Statistics, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Balbach, J. Davis, T. Davis, Eisenmenger, Fousek, Keran, and Koch, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Cleveland, Kansas City, Boston, New York, San Francisco, and Atlanta, respectively

Messrs. Broaddus and Syron, Vice Presidents, Federal Reserve Banks of Richmond and Boston

Mr. Supel, Senior Economist, Federal Reserve Bank of Minneapolis

Ms. Clarkin, Senior Trading Officer, Federal Reserve Bank of New York

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CHAIRMAN VOLCKER. We need approval of the minutes.

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. There's a short report on foreign currency operations. There weren't many operations.

MR. CROSS. I've had to suffer a lot of comments on that! [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any comments or questions?

MR. RICE. What was the second occasion when you considered intervention?

MR. CROSS. It was an occasion when the dollar was moving up very rapidly toward the 2.30 to 2.32 level. It occurred at a time when questions were being raised about the German situation after the Chancellor's health problems and after some money figures here had suggested that interest rates might be required to go up again at that point. The dollar spurted up from about 2.28 to 2.32 and that caused a considerable amount of consternation. But [the advance] lasted only a matter of hours and the dollar then began to retreat.

MR. RICE. There was no one particular event except the Chancellor's health?

MR. CROSS. I don't think the rise could be associated with a single event at that point; it was certainly not comparable to the assassination of President Sadat.

CHAIRMAN VOLCKER. You have a recommendation for us?

MR. CROSS. Yes I do, Mr. Chairman. All of our swap arrangements will be coming up for renewal before the end of the year, and I would request the Committee's approval to roll them over for another year in the normal way. Since last year [there have been changes] in three cases. The central banks of England, Canada, and Mexico have specified the investments against which the interest rates should be calculated in the event that the Federal Reserve were to draw on those swaps. For good order we would propose that the change in the arrangements with these three central banks be incorporated in the language at the time we renew them.

CHAIRMAN VOLCKER. Are we symmetrical in all these now in terms of that?

MR. CROSS. Yes.

MR. ALTMANN. Yes.

MR. CROSS. Well, symmetrical--

MR. TRUMAN. The change was made last year for all the cases where we would draw at the foreign rate. When we did it for the Germans, we did it for all of them. The problem was that not all the countries were ready to come forward with a rate at that time, so the swaps for those cases were rewritten to say "an appropriate domestic rate" which in our case--

MR. CROSS. And these three do not correct all of them. There are still some in that unspecified category.

VICE CHAIRMAN SOLOMON. We had a long negotiation, you remember, with the Japanese; it was not so long with the Germans.

CHAIRMAN VOLCKER. Well, there's a question of the interest rate. There's also a question of the exchange rate, which I now forget--

MR. TRUMAN. Well, that was eliminated, too.

CHAIRMAN VOLCKER. The exchange rate was different when one side was drawing than when the other side was drawing.

MR. TRUMAN. That has all been put on a symmetrical basis. On the one hand, it's on a symmetrical basis; on the other hand, the interest rate was adjusted at the same time.

MR. CROSS. Some of them are not specified.

VICE CHAIRMAN SOLOMON. Our biggest problem with the Japanese, which we finally solved, was not getting a market rate because their Treasury bill rate was But we finally worked that out. I had to put a lot of pressure on the Ministry of Finance as well as on the Bank of Japan. There are two different versions; but they're completely satisfied now with the arrangements over at the Treasury.

CHAIRMAN VOLCKER. Well, we seem to be in reasonable shape on these arrangements regarding the terms. Do we have a motion?

MR. TRUMAN. Mr. Chairman, I think you're remembering the risk-sharing, and that is what was dropped in all the cases. The substitution that was made was that we would at the same time take--

CHAIRMAN VOLCKER. I'm remembering the risk-sharing. I don't remember the specifics of it at this point, but I won't--

MR. TRUMAN. For the five that we had drawn upon in the post-1973 period, they had a provision that they would share the risk on our drawing. That was the--

CHAIRMAN VOLCKER. Yes, 50-50. Well, do we have motion?

VICE CHAIRMAN SOLOMON. So moved.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. If I hear no objections, you are authorized to negotiate these on substantially the same terms as they now exist.

MR. CROSS. Thank you.

CHAIRMAN VOLCKER. Mr. Sternlight.

MR. STERNLIGHT. Statement--see Appendix.

CHAIRMAN VOLCKER. Questions or comments?

MR. ROOS. Yes, Mr. Chairman. Peter, at these meetings we set desired rates of growth for M-1B. In the last 7 or 8 months [M1-B growth has been] significantly below the lower end of the target ranges that we've set. As I listened to you, I got the impression that one of the reasons for that is that borrowings, as they actually evolved, were at a lower level than the assumptions we had made at our meetings. Under our procedures, when borrowings are below what we anticipate they will be, do you adjust the nonborrowed path or the total reserve objective to compensate for that reduced level of borrowing?

MR. STERNLIGHT. The decline in borrowings over the past six months was a consequence of the lower-than-path money growth. Money grew less than was targeted, [but the target] was the basis for setting path patterns for total and nonborrowed reserves. In particular we pretty much stuck with our path for nonborrowed reserves as money grew more slowly and the banking system needed less reserves. Because of that slower money growth borrowing came down, and that has been reflected in a considerable decline in rates.

MR. ROOS. Well, I was under the impression that we set targets and then we do whatever we think is [necessary] to achieve the M1-B target, for example. So, if money growth is coming in below, and if borrowing comes in below, don't we take some action to counter that situation so that we can achieve the target that we've set for ourselves? It seems to me that if we adjusted upward the nonborrowed reserve path, we'd get total reserves at a higher level and thereby we'd be able to achieve, or at least come closer to achieving, our M1-B targets. Or am I [wrong]?

MR. STERNLIGHT. Well, there have been adjustments of that kind. There have been adjustments in the other direction when money growth ran way ahead of desires. There was a small adjustment of the nature that you've described within this last period; the nonborrowed path was raised because we were falling below in money growth as the period unfolded.

MR. ROOS. But as I listened to your report, I got the impression that these adjustments were very small and slight. Why aren't they made to the extent necessary to achieve the targets that we set?

MR. AXILROD. President Roos, the Committee also had an M2 constraint.

MR. ROOS. Well, had we adjusted nonborrowed reserves to achieve our M1-B--. Let me put it differently. You're suggesting that we did not respond as might have been necessary to achieve our M1-B target because we would have overshot the M2 target?

MR. AXILROD. If the Committee had only an M1-B target and was determined to achieve it no matter what was happening to M2 or anything else, then, of course, we would have had to push reserves in and raise the nonborrowed reserves path enormously, with a resulting drop in interest rates and presumably more marked expansion in M2 and other things.

MR. ROOS. So, Steve, we're almost back to where we were when we had incompatibility of achieving interest rate targets and aggregate targets. Now we have two aggregate targets that sometimes are incompatible. Is that what you're saying?

MR. AXILROD. Well, yes, in some sense maybe they are incompatible. You can choose one or the other; you can't choose them both. But given the [recent] changes in financial technology and the way people are behaving, the Committee inevitably has to make the judgments it has been making: That it's going to take this attitude toward one in case the other goes off and vice versa.

MR. ROOS. Could we set those, if we really wanted to, and lock the doors? Could we set those two aggregate targets so that they would be compatible so you could accomplish both of them?

MR. AXILROD. Only if God were sitting at this table! Let me tell you, it'd be--

MR. SCHULTZ. Would you care to designate him?

CHAIRMAN VOLCKER. Now that Mr. Axilrod has consulted all of us--

MR. ROOS. It depends on whether you're a smoker or a non-smoker.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Steve, do you believe pretty confidently that if rates had come down M2 would have speeded up in view of the rate sensitivity that's so much in [evidence] now?

MR. AXILROD. Well, in the short run our experience is that [growth in] money market funds tends to speed up with rate declines because of the lag in [the adjustment of] their rates. As rates declined this time, we found a rather unusual experience in that savings deposits at banks accelerated. I assume it was just some sort of cautionary inflow. But all the evidence we have is that, yes, as rates decline we still tend to see growth in M2 as deposits become a little more attractive relatively speaking. Now, this doesn't hold quite to the extent it did before because we do have components of M2 that move with market rates.

MR. BLACK. That would be interesting to watch over time. I'm not sure that that will [continue].

MR. AXILROD. Well, it is atrophying a little, that's quite right.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Just following up on your comment, Steve: Earlier in the year, of course, we did have that M2 constraint as we all know, but at the October 6th meeting that proviso clause on M2 was dropped and we set sort of independent paths for M1-B and M2. It was my impression, and you probably have more recent data than I've been able to look at, that in this latest period since the October meeting both M2 and M1-B have fallen below the path we set. Is that true?

MR. AXILROD. The M2 figure for October has fallen below by about a couple of percentage points; our expectation at the time that we [constructed] the path was [a growth rate of] 11.8 percent and it was published at 9.3 percent. In very recent weeks, the latest data show an upturn in M2 because of the persisting strength in money market funds and, as I mentioned to President Black, some strength that we've observed in savings deposits at commercial banks. So we think we're on a trajectory that gives us a very high November. Again, most of that is just extrapolating the trajectory of the last couple of weeks.

MR. BALLES. Well, in view of the fact that we apparently have fallen below the paths set at the October 6th meeting on both of the Ms, I was a little curious about Peter's remark about the very small upward adjustment made in nonborrowed reserves. I think it was pretty darn small. Do you happen to recall the amount, Peter? Wasn't it about $60 million?

MR. STERNLIGHT. $55 or $56 million or something like that.

MR. AXILROD. It was $100 million for a week; in terms of a 3-week average it was $56 million or something like that.

MR. STERNLIGHT. If I could add one other point that seems relevant to me: As you know, there has been a considerable decline in rates as money growth has weakened relative to the longer-run paths. I think we've gotten away with that in the market in the sense that the basic credibility of the Fed's longer-term restraint policy has not been seriously questioned. A minority of voices--maybe one or two--has been heard here and there on the fringes raising a question, but by and large the Fed's credibility has not been questioned. I think a very vigorous response to achieve an M1-B target when it was falling considerably short would have very much endangered that [credibility] to the point where it would have been questioned in this period.

CHAIRMAN VOLCKER. Any other questions? If not, we can ratify the transactions if you are prepared to.

MR. SCHULTZ. I move it.

MR. WALLICH. Second.

CHAIRMAN VOLCKER. Without objection; that wasn't enthusiastic on the [motion] and the second. Mr. Kichline.

MR. RICE. Excuse me, Mr. Chairman. Is it too late to ask Mr. Sternlight a question?

CHAIRMAN VOLCKER. No. Excuse me, Jim.

MR. PARTEE. It certainly isn't.

CHAIRMAN VOLCKER. If it's one short question.

MR. RICE. Well, I'd like Peter to expand on that last statement. What makes you so sure that the credibility of the System would have been called into question more vigorously had we tried to keep money growth closer to the targets? Isn't that just your impression? You don't have any hard [evidence].

MR. STERNLIGHT. It's judgment, Governor--I can't prove it--just from the way that our responses are watched so diligently by an army of Fed watchers in the markets. They are watching to see what our response will be and there are suggestions from various quarters that money is falling short and we ought to be doing this or that to repair that situation. I had the impression that we were getting close to the point where credibility could be questioned each time we made some overt move, whether it was on the discount rate or putting in reserves at some particular funds rate level or something. We've always run little risks of that kind. We came through it without really setting off any significant reaction but I don't think we were that far from that on various occasions as we came through this declining rate period.

CHAIRMAN VOLCKER. I might add that we always have the luxury here of looking at these things ex post. As I remember this intermeeting period--and I may have my timing off a little--we had a big increase in M1-B early in October. And the reason October turned out to be low was the figures late in October that we didn't know about until we were in November. Now, in the middle of November, we look back and October looks low. When we were in the middle of October, it looked high.

VICE CHAIRMAN SOLOMON. Also, pumping in more reserves when the economy is weak to compensate for a [shortfall] will not necessarily result in an increased money supply. What one may find is that it just causes a further drop in borrowing and more downward pressure on interest rates. We may end up not being any closer to our monetary target and it may bring about a more precipitous [rate] decline.

MR. PARTEE. Well, that's what interest rates do. They get you closer to your monetary target if you move--

VICE CHAIRMAN SOLOMON. Yes, but there's a delayed effect.

MR. PARTEE. Yes.

VICE CHAIRMAN SOLOMON. It may not show up for quite a few months.

CHAIRMAN VOLCKER. Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Why don't we go ahead with Mr. Axilrod and then we'll call it all open [to questions].

MR. AXILROD. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Well, both statements gave us a little menu of concerns. I think the time has come for comments on the economic scene and related comments you might want to make on the financial scene.

VICE CHAIRMAN SOLOMON. What's your peak-to-trough projection, Jim?

MR. KICHLINE. About 2 percent if one were to go from Q1 1981 to Q1 1982, and that compares with a mean of postwar contractions of about 2-1/2 percent.

MS. TEETERS. One question, Mr. Chairman: The third quarter inflation rate turned out to be quite a bit higher than we had expected and I wonder if there are any special factors there or is it something that's likely to continue? What are the risks on that side?

MR. KICHLINE. It was a couple of special factors. One relates to the inventory deflator and a technical problem that we think will be reversed. Another was actually a positive feature that turns out to be negative in the short run. We had a much steeper decline of import prices and in that quarter, since they're subtracted, it tended to boost the inflation rate. But we think on average the changes that we've made to the third and fourth quarters don't represent a fundamental change in the inflation outlook, although I would say some things, such as service prices, have been coming in higher than in our previous forecast. But it's not a big problem at the moment.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I have a question, Steve. As I understood your rationale, you're concerned that if interest rates fall more quickly than somehow would be warranted by present economic conditions, that would have adverse consequences. Am I not correct in saying that the only way to stop interest rates from declining at what anyone might think is an excessive rate is to withdraw money, which has a depressing effect on M1-B? Is that correct so far? The only way to keep interest rates from dropping by what anyone might think is a precipitous amount is to be frugal in the way we supply reserves?

MR. AXILROD. That's one way, assuming GNP. GNP could be different.

MR. ROOS. All right. Let me ask this then. If we believe, and maybe we don't, that there is some relationship between economic activity and the rate at which the aggregates grow, especially the narrow aggregate, and if in order to keep interest rates from plummeting we keep the aggregates below what we think is [an appropriate] targeted range, can't that exacerbate the recession? And if the recession is more pronounced, won't that cause interest rates to be low anyway? In other words, where does that string of reasoning --if you can dignify it by calling it reasoning--break down, Steve?

MR. AXILROD. Well, the context that I had in mind was that the Committee is making a short-run decision for, let us say, the next six weeks. And whether that decision is for 5 percent growth in money, or 6 or 7 percent--if money growth turned out to be any one of those [rates]--and then the Committee went ahead and attained its 1982 tentative targets or something like them, I simply didn't think that the difference in those growth rates would matter very much.

MR. ROOS. Nor do I.

MR. AXILROD. And they won't affect the year as a whole--the result for the year 1981--because in large part that's given. Or at least the year isn't much affected by those growth rates.

MR. ROOS. Yes, but I thought it--

MR. AXILROD. So, that drove me to worrying about what kind of volatility might be promoted in credit markets with effects on expectations from short-run efforts [to increase growth], given the fact that I assumed the Committee was going to phase down into its 1982 targets, or phase down as the year began. That drove me into these muddy areas of how people perceive what happens in credit markets. And I felt that if rates dropped sharply before anyone felt that a sustained economic weakness was in train, that would start a speculative bidding on commodity markets, use of credit for those purposes, and things like that.

MR. ROOS. Well, I would share your thinking that what we do today in the short run isn't important. But my question--and maybe I was premature and it should be considered when we make our longer-term plans--was on this whole question of the relationship of [declining] interest rates and the aggregates. I think that should be considered at that time, though maybe not today. I thought that you were really addressing the longer-term game plan and--

MR. AXILROD. I was trying to say, President Roos, that an element in today's short-run decision probably should be how the Committee wants to phase into the targets for next year.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. In looking at your calculations of the effects that the different alternatives we're considering would have on rates, I noticed that you're projecting that from today until our next meeting in December, which is a period of 5 weeks I believe--and coming into this meeting I thought Peter said that the fed funds rate is running a little over 13 percent right now--

MR. STERNLIGHT. Right.

MR. FORD. So, you're saying that were we to choose to expand M1-B over the next 5 weeks at a rate under 9 percent, we could have a 100 basis point drop per week in the fed funds rate potentially. That is the worst we could have, is that right?

MR. AXILROD. Well, that isn't the worst. That's our best guess of what these relationships are.

MR. FORD. Is that right?

MR. AXILROD. Best estimates until--

MR. FORD. Well, that did happen for a while. As I recall, when we put on credit controls over a year ago, we did have the rate dropping 100 basis points a week.

MR. STERNLIGHT. Even more for a couple of weeks in April. It was between 100 and 200 basis points a week for a few weeks.

MR. FORD. I'm wondering what is in your modeling. That was a very unusual period. If we were trying to achieve some step-up in M1-B to get back to our announced targets for this year, I'd be surprised, in the absence of credit controls, if we were to get anything like the kind of precipitous drop in rates that we had under credit control. Wouldn't you? How does your model generate this?

MR. SCHULTZ. It depends on where we put the borrowing. If those borrowings get too low, then rates can drop pretty fast.

MR. AXILROD. Well, the model would have generated much bigger drops in rates than--

MR. FORD. Do you mean, in other words, that this is an adjusted number [from what the] model--?

MR. AXILROD. Well, no. The credit control program [produced] drops in money supply well below what was targeted at that time. So, in order to hit the target, the declines in rates would have been even more--much, much larger. So, this sort of assumes hitting the targets. Moreover, it does it with only 6 weeks to go; so you have to get a lot of movement in it.

MR. FORD. On the credibility question that you mentioned, Peter, are you concerned also about our credibility in terms of the aggregates and whether or not we're trying to keep reasonable the [deviations from] the long-term paths we've set? Isn't that also a credibility problem in addition to the worry about what happens if the rates drop?

MR. STERNLIGHT. I think so, sure.

MR. FORD. In making your judgments, then, how do you judge one kind of credibility against the other?

MR. STERNLIGHT. Well, carefully.

MR. FORD. We had some builders circling the statue in front of the Atlanta Fed and they were thinking about hanging Mr. Volcker in effigy. Their argument was: What are you guys doing? You're not taking care of things. You ought to stop worrying about these rates and let them come down. We are dying.

In that connection, I noticed in the Greenbook that your housing forecast for the fourth quarter, Jim, shows 870,000 starts on average. That must mean there's a bottom below that, which we're going to face either this month or next month, where housing starts are going to be reported at under 800,000 units. Is that what you [expect]?

MR. KICHLINE. No, not necessarily. We have 918,000 or something like that in October. So, it's below 900,000 on average for the next--

MR. FORD. It has to be. If you have an average of 870,000 and you have 918,000 for the first month, where is the bottom? I'm worried. They came circling our statue of the eagle when starts were 900,000. What are they going to--?

MR. ZEISEL. 840,000 is our low in [the quarter].

SPEAKER(?). We'll have a bald eagle!

CHAIRMAN VOLCKER. Having resolved that piece of arithmetic, we'll go to Mr. Winn.

MR. WINN. Mr. Chairman, it disturbs me to sit here and let us contemplate what is really a fiction, which is these numbers that we're going by. I'm watching the volume of our check clearings in Columbus suddenly shoot up, which is an unusual phenomenon at the moment. If you look into that, it's unbelievable the money fund transfers that are being put through by one our Columbus banks. I wonder if the numbers we are dealing with here were closer to the reality of transactions balances if we'd have the same kinds of reactions we're having to these numbers. To play these numbers out seems to me to be a serious mistake in terms of transactions balances against the economy. I think these are too low in terms of reality if we adjust for the money funds, which are growing very rapidly [based on] the push being made, at least in our District, not only in terms of large corporations but of individuals moving into these money funds. The pressure is really very great to get individuals to convert into money funds, which are transaction balances. It seems to me that it would behoove us to move promptly to find out what proportion of these money funds is in fact transactions balances and to start to factor that into our thinking about these aggregates, if this becomes a guide in terms of our policy.

My second point is that it seems to me we're stuck not only with arbitrary numbers but that our perspective is too short. If we think a bit longer term about what we're trying to do, we get away from some of these extremes in our thinking concerning this 5-week period. Third, to try to get away from this damn base drift problem, which is going to kill us on the one side as it did last year on the other, I'd put this in perspective by going back to the fourth quarter of '79 and then making some growth rate projections out into these periods for what it takes to get us on a reasonable path from that level until the March figure gives us somewhat different numbers than have been presented to us here. So, this is a series of things that we need to think about in our policy considerations.

On the economic front, I have a concern which is not shared by my colleagues, I must confess. I think we've kind of gotten over the interest rate bulge temporarily here in terms of pressure on corporations. But I have a feeling that the profits squeeze is setting in and that some managements are going to throw in the towel and that we're going to have more financial problems in the months ahead than I think are factored into some of these forecasts. I don't know what the fallout of that is going to be in terms of psychology [and the effect on] this turnaround that is projected in the months ahead. This really is causing me concern because of the fallout that would have for financial institutions that think they're in pretty good shape and could suddenly wake up with some rather sick loans on their hands that really aren't [known by] the public.

CHAIRMAN VOLCKER. Well, let me make a couple of comments on your comments. On that one, I am somewhat encouraged in a perverse sort of way that the bankers I have been talking to recently realize that they may have some credit problems on their hands, if realization is the first step toward appropriate policies.

MR. WINN. That's right.

CHAIRMAN VOLCKER. On your first point on money market funds, I agree with the general direction of your comment. It's very hard to make statistical analyses. We've tried to make some. I forget all the assumptions, but on what I think would be considered the most conservative assumptions that adds somewhat over 1 percent to M1-B in terms of transactions balances. But that kind of calculation allows nothing for indirect effects, for example that an individual minimizes his transactions balance simply because he has a money market fund and knows he can draw upon it even if he doesn't draw upon it frequently or at all. [The problem] is a matter of continuing concern. But there's no figure that comes out that says this much of the money market funds is transactions balances and that much isn't because--

MR. WINN. Can't we go back and take a look at some of these accounts and see to what extent they really have--?

CHAIRMAN VOLCKER. Well, these calculations derive--and I don't know how good the basic data are--[from information] that says there's this much turnover or this much check usage on these money market funds. [That is, if] they had a normal kind of velocity and if they were NOW accounts instead of money market funds, they'd be this big. And that accounts for a relatively small fraction of money market funds. But still, they've been growing so fast it does make an impact.

MR. AXILROD. We also had an informal Michigan survey where we asked people what percentage of the money market funds were transactions accounts to them and what were such and such? A very small percentage was transactions.

MR. WINN. What strikes me is the number of people one talks to who are becoming aware of them and now starting to use them. That really is accelerating.

MR. AXILROD. Well, this survey was conducted a few months ago.

MR. WINN. That's the thing. I think in the last few months we've seen a really marked shift into this sort of account.

CHAIRMAN VOLCKER. I don't have the figures with me to look at these things in a longer-term perspective, but I'd like to look at that. I should get those figures, Steve.

MR. FORD. I have it in a chart.

CHAIRMAN VOLCKER. The year-to-year changes are quite orderly.

MR. FORD. If you took the '79 base that [Mr. Winn] mentioned and [drew] a cone out from '79--in other words, if there were no base drift--the growth of M1-B that we've had would put us inside the range, just below the middle according to my chart.

MR. AXILROD. Mr. Chairman, as a matter of interest, I've put the 1981 average over 1980 in the Bluebook.

MR. SCHULTZ. Yes, it's there in the back of the Bluebook.

CHAIRMAN VOLCKER. Where?

MR. AXILROD. It's on page 6; it's the last line for M1-B. This happens to be a year where the difference between the Q4-to-Q4 figure and the [yearly] average-over-average is a lot bigger than it is ordinarily. The difference is ordinarily more like 1 or at the most 2 percentage points. As you can see, it's close to 2-1/2 or 2-3/4 percentage points. That is, M1-B looks like it will grow about 4-1/2 percent year-over-year whereas for Q4-to-Q4 it's only growing--

CHAIRMAN VOLCKER. These are adjusted figures?

MR. AXILROD. Yes, this is shift adjusted.

MR. PARTEE. That's because we got [growth] early in the year; so far it has been high.

MR. AXILROD. Yes. I'm not sure in this calculation whether we ended up shift adjusting 1980, but that would lower it from 4.5 to 4.4 or 4.3 percent; it wouldn't be that much of a difference.

CHAIRMAN VOLCKER. We started high?

MR. PARTEE. Yes.

MS. TEETERS. This would reverse next year, Steve. If it starts low, then it will end up--

MR. AXILROD. Oh, yes. It averages out that over [the two] years they both come out the same, I think.

CHAIRMAN VOLCKER. I might also say that I have no confidence in this shift adjusted figure anymore. I think it was an appropriate thing to do earlier in the year. But at some point it loses me, in terms of significance. I think we have already passed the point where it loses me, but it's not--

MR. PARTEE. It's having very little effect now.

CHAIRMAN VOLCKER. Well, it had a quarter of a percentage point or more [effect] in the second half of the year, I think.

MR. AXILROD. Well, it's not--

CHAIRMAN VOLCKER. It's nothing drastic.

MR. AXILROD. It's not unreasonable to say, Mr. Chairman--I hesitate to mention it--that the staff, and in a sense all of us, underestimated the offsetting downward shift we would get [along with] the upward shift in M1-B from shifts in savings accounts. There were downward shifts in movements of demand deposits into other things.

CHAIRMAN VOLCKER. Well, that's the money market fund question.

MR. AXILROD. That's right. In some sense we have two offsetting errors here.

MR. CORRIGAN. But it seems to me that it all works in the same direction. If you go back to the beginning of the year and look at the spread between the M1 and M2 targeted growth rates, it was going to be 2-1/2 percentage points. But we had fudged that; it was really something like 3-1/2 points. Now, if you look at where the year is probably going to come out, that spread that we thought was maybe 3-1/2 is going to be 7-1/2 percentage points. The 4 percentage point difference in the observed spread versus what we thought the spread was going to be suggests to me that the weight of the argument is overwhelmingly in the direction of M1-B being understated, whether it's because of money market mutual funds or whatever. While I'm under no illusions that we knew exactly the relationship last January either, that alone leads me to the conclusion that I simply am not nearly as preoccupied with what the statistical measure of M1-B is versus what I think the reality is.

CHAIRMAN VOLCKER. Mr. Partee.

MR. PARTEE. Well, I just wanted to point something out--not on this subject--[though] I agree that the velocity of M1-B has increased because of the money market funds. After all, we'll probably have a 9 percent increase in nominal GNP this year with growth of only a couple percent on M1-B, which is unprecedented. That has to mean a considerable shift has occurred.

But what I wanted to point out was that when Steve speaks about the trajectory--plotting a course that would take us through the winter and into the spring--he has been very careful every time he has referred to it in a statement to say "assuming the economic projection." And I would argue that this begs the question, because I have a certain amount of sympathy with Larry's first question. I held my hand up when he asked it, though it has been some time since Larry made his comment. There could be a circularity here that in effect has a trajectory to no place, or as we say in regard to the discount rate "a bridge to nowhere." That's because, in fact, we may find that the nominal GNP numbers fade as we move ahead. We've had a little of that, certainly, in the fourth quarter [with GNP] being quite a bit weaker than we were anticipating all year. I have a sense of a little shortfall from our projections as we've gone through the year. We've certainly had big shortfalls in relation to our expectations on M1-B. I looked at it and we have been below our expectations of M1-B at these meetings for six consecutive months, and the average shortfall has been 7 percent over that 6-month period. We've even been short on M2 compared to our expectations, the paths that we selected when we went into the period. In the case of M1-B, that's partly because of this velocity problem. But I think it's partly because of shortfalls in economic performance, too.

It's hard for me to believe that there will not be an economic recovery commencing in the second half of next year, given the size of the deficit that we'll have and the further cut in taxes that will occur as of July 1st. But it's a fair piece until the middle of next year, and I'm not at all sure that we can say with great confidence that the economy might not decline a good deal further below the projection, [say, by] the end of the first quarter, which could give us quite a serious problem as it occurs. If that is true, and if we hold up interest rates, then we will get the contraction in transactions balances that will make possible a continuation of poor business. So, I just wanted to point out that Steve has been very careful every time he referred to the longer-run planning always to assume as a caveat that the economic assumption was right.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I keep hearing, particularly from small businessmen, that there is a lot of pent-up demand both in terms of consumer spending and investment demand, if only interest rates would come down. They're referring mostly to bank rates and mortgage rates. I wonder, Jim, if there's any reason why that should be more true this time around than in previous recessions--that there would be more interest rate sensitivity on the demand side. One can say that maybe rates were so high that people backed off. But if it's true that there is this pent-up demand, that seems to me to argue for a shorter recession of a more traditional V-shape. But I haven't been able to come up with any really convincing reasons why it's necessarily true that there ought to be more pent-up demand waiting on more interest rate [declines] this time than other times.

MR. KICHLINE. Well, I think it's a mixed picture. A couple of years ago we had what were really fairly strong forecasts, given the interest rate assumptions. Our thinking there was largely conditioned by the inflationary experience and a rough calculation of real interest rates. We didn't think real rates were that high and we had relative to the model forecast--at least our own model--a fairly strong GNP projection. Looking at it now, the argument is a bit different. Our inflation forecast, looking ahead, is coming down. In the mortgage market there is a good deal of underlying demand that's related to demographic factors, and the interest rate is a constraint. But I'm not sure I'd frame it in terms of the interest elasticity having changed; we've just choked off a lot of potential demand in the last two or three years. In the auto area, our view is that interest rates are probably a small factor in the depressed state of the market. It is prices and incomes but not interest rates so much. So, I don't perceive the notion that rates coming down a bit--say the mortgage rate goes from 18 to 16 percent--as a dramatic factor. Now, if you talk about the mortgage rate coming down into the 12 percent area, for example, then I think big things will happen. So, rather than focus solely on the interest rate effects, we believe there are many things going on in various markets. It's not just that the interest rate elasticity is so high that we're going to get a big bounceback, given where we're starting.

MR. BOEHNE. One other comment on the inflation front: I had a number of meetings with groups of 15 or 20 people and I asked them what kinds of assumptions on inflation they were building into their business budgets. I didn't find an overwhelming number of people who were reducing their own internal assumptions on inflation. Out of a group of 15 or 20 people, maybe 2 or 3 people were actually lowering their budget assumptions. But I did find a difference in businesses that are unionized and those that aren't unionized. Unionized businesses tend to see noticeably less feistiness on the part of the unions in terms of wage demands, but in the nonunionized areas I don't find that happening.

CHAIRMAN VOLCKER. What do you find to be the typical inflation forecast in these planning budgets?

MR. BOEHNE. I would say most are in the 9 to 10 percent range, with a few outliers down around 8 percent.

CHAIRMAN VOLCKER. That accords with my experience, but I find more outliers above than below.

MR. BOEHNE. Well, I hear people who talk about [inflation] above 10 percent. Probably more people say they see it above 10 than see it at 8 percent; but most of them are around 9 to 10 percent.

VICE CHAIRMAN SOLOMON. The people say that they're planning on a 5 to 6 percent wage increase next year. But they are nonunion. They pay relatively low wages; they [start with] the minimum wage, I think.

CHAIRMAN VOLCKER. Mr. Rice.

MR. RICE. Mr. Chairman, at the last several meetings I've been saying that the economy was sluggish, bumping along somewhere between no growth and very low growth. I thought that was a good thing in terms of a desire to reduce inflationary pressures and I thought it would be good if we could keep the economy in that mode. But now we see that the economy has not remained in that pattern. Nearly all of the indicators point to a recession. And, as the Redbook indicates, pessimism is widespread among businessmen. It appears to me that the only question really is how deep the recession is going to be. My own judgment is that the staff forecast is about right. I would differ only slightly as to the timing of the turnaround. The staff sees a mild upturn in GNP in the second quarter of next year. I do not see a turnaround appearing as early as the second quarter. I do not see the mild pickup in housing and in automobiles and in inventory that the forecast is based upon. I think a turnaround has to await the tax cut of midyear and that it probably will be toward the end of the third quarter before we see any real signs of recovery. So, I would put the recovery further back in time, which means that we're likely to see very low economic activity continuing longer. In other words, the duration of the recession would be longer than is projected. I'm also more optimistic about the inflation picture for next year. In my view the course of inflation will be somewhat less. The staff is projecting an average inflation rate of something like 8.8 percent, and I would expect it to be slightly lower than that.

I was interested to hear Mr. Axilrod say he saw significant differences between this downturn and the one that occurred in the spring of last year. I certainly agree with that. This is a much more classic recession. I don't think it will be V-shaped; I don't think there will be a very quick snapback because the conditions are different and the basis for a quick snapback in consumer and business spending seems not to be present now. The main issues that seem to be before us then are: (1) How much of a drop in interest rates would we find acceptable in the current circumstances; and (2) How much of shortfall in the growth of M1-B from its target range would we find acceptable. And related to both of these questions is, of course, the credibility issue. What happens to our credibility if we allow interest rates to fall below whatever level we find acceptable and what happens to credibility if we continue to allow money growth to fall substantially below the target range? I see our credibility being called into question much more when we are seen as letting up in a situation where inflation is gathering momentum and when interest rates are rising [than if] money is tight and we appear to be letting up--and I emphasize appear--in a situation when interest rates are falling and the economy is weakening. In current circumstances it's much more important to be perceived as sticking to our objectives and taking our monetary growth target seriously. Therefore, at present--and I refer now to the period over the next six weeks to two months--it's important to be seen as not contracting the narrowest monetary aggregate, M1-B, further than we had intended to six weeks ago. I would think that our credibility depends a great deal at this time on whether we are willing to appear to move in the direction of trying to achieve our target for M1-B.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. Well, one comment about what Mr. Boehne said: As far as latent demand is concerned, we've had a policy of monetary restraint for a couple of years now and it does stand to reason that in the interest sensitive sectors, which have been under pressure for that length of time, there would be some latent demand--certainly, for example, in housing. The auto sector would seem to have some latent demand because of scrappage on the one hand and because of the recent very rapid rise in used car prices; one would assume that would have some connection. I happen to feel that auto sales may be a bit more interest sensitive than the staff does, as a psychological factor, if nothing else. I recognize the sticker shock phenomenon. Another interesting thing to note is that in the quarterly survey of the National Association of Small Businesses a large percentage of respondents say that their biggest problem is interest rates. But only a portion of those people say that the problem is that they are under terrific pressure. A lot of very solid small businesses say that they'd like to expand if interest rates would come down, so I think there's considerable latent demand in that area as well.

MR. BOEHNE. I think you're quite right about that.

MR. SCHULTZ. Let me speak to what Bill Ford had to say, because I think that's the crux of the matter at this point in time. I believe that the very high interest rates have been a primary cause of the recession we're in. If that's the case, then we certainly need to have lower interest rates before the economy begins to pull up. And I think we clearly do need lower interest rates. There are three things, though, that bother me a great deal about the speed and depth of that drop [in rates]. The first is that if we let borrowing go too low--I'm not sure about Steve's frictional level of $50 to $100 million because I have a feeling it may be a little higher--we get into a situation where the funds rate could drop very precipitously. And if the funds rate were to drop to a negative real rate, that would be an indication to the market that would not be very favorable. You asked Peter what his judgments were about expectations. The fact is that the army of Fed watchers out there has history on its side in feeling that we are going to cave in. We have in the past and they continue to expect history to repeat itself. So, I think a very sharp and precipitous drop in the funds rate could have serious expectational consequences.

The second part follows on that expectational point. It is important that we get mortgage rates down if we're going to get some recovery in housing. Now, how do we go about doing that? Well, if we get more savings flows into the thrifts, that helps. If the rates on all the other alternative investments come down, then the mortgages will look better. But the fact is that the thrifts have been killed by investing in mortgages over the years, so the expectational factor is very important for them in terms of when they're going to start making mortgage loans again. The California thrifts keep coming in and telling us that they're not making any mortgages at all even with these very high rates. So, how do we get them to [make such loans]? I'm not sure that a very precipitous drop in short-term rates is the kind of thing that would make the thrifts feel that they'd want to go out and start making mortgage loans again. The expectational factors are important there. I don't really know how to assess that, but it's something to be considered.

The final thing that just scares the devil out of me--it gives me some nightmares--is what will happen if we do get this recovery in the first or second quarter and then the tax cut comes in; I just have to feel that interest rates are going to start back up again at some point in time. Now, 1982 is an election year. What kind of problems will this country face in its anti-inflation efforts if we are in a period of rising interest rates in a political campaign? On the question of how rapidly interest rates come down and how rapidly they come back up, in talking to small businesses of all different kinds, my sense is that there are thousands of them out there that are hanging on by their fingernails and they're going to continue to hang on when they see interest rates coming down. But when they see those interest rates start to turn back up again, I think a lot of them are going to let go, and we could be facing a really, really serious problem. Willis Winn brought in a letter this morning which he says is typical of what he has been getting from businessmen. In effect it says that the Fed is being too tight and it's causing the recession and not letting the President's program work. It's that kind of argument. Now, what happens if we get into the summer in a political campaign under those kinds of circumstances? I just have a feeling it could wreck the whole anti-inflation campaign and then we're in deep trouble. I think we do need to get interest rates down. It's important. But the speed and depth of that drop and the potential for the rebound is something that we really have to keep in mind.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, some of the things I'm going to say echo what Fred has just said. As I listen to the staff, they are telling us, I think, that we are in a classic recession now. It is quite pervasive across sectors; it has cumulative characteristics, but the economy is by no means falling apart. We are not looking at a 1974-75; we're not looking at a second quarter of 1980. I find myself in broad agreement with that, and I think that is what the tone of the Redbook is saying also. But, frankly, I don't like what we're going through. I would much rather have seen a continued more or less sideways path instead of heading into a recession. If we look back at what has been happening in the last two years, we find that the economy got too weak in the early part of 1980 and it got too strong in the last half of 1980 and then it was too weak again. In all candor we have to acknowledge that the behavior of financial variables has been principally responsible for that. I don't think we ought to cast any blame. If I had been responsible for running the whole thing myself, I don't know that I could have done any better and I may well have done worse.

I certainly agree with Willis Winn's comments that we're looking at the behavior of a measure of transactions balances that we have not the foggiest notion of how to interpret. But I don't think the answer is simply to recast our statistics, because what we're going through is a wholesale change in ways of portfolio management on the part of both businesses and individuals. And it's going to take a long, long time for this to shake down until we finally understand what these monetary aggregates mean. I think what we have to do is to take into account what is happening to interest rates, at least to some degree; and there just isn't any doubt in my mind that interest rates have gone through much too wide swings in the past couple of years. In retrospect, I come to the conclusion that when we let the fed funds rate get up to the 18 to 20 percent range, the behavior of the economy subsequently has become too weak. And when we let it get down into the 8 to 10 percent range, the economy has become too strong. Now, those are rather wide limits, but somewhere between those two limits is where we want to be.

I agree with Mr. Axilrod's comments that the economy is different now than it was in the second quarter of 1980, so we're not going to see the same kind of response that ensued upon removal of credit controls when interest rates on short-term securities were slightly below 10 percent. But let us remember also that we have an enormous amount of fiscal stimulus coming along in the latter half of next year, and that's going to work the other way. And I agree with Ed Boehne that we have a lot of pent-up demand out there that could begin to affect the economy if interest rates come down a lot further.

The most important policy question we need to focus on as a Committee today is how far and how fast we want interest rates to fall from here. I would remind you that interest rates are already lower than the trough level of interest rates that underlies the staff forecast. The staff forecast has a trough level of Treasury bill rates--that is, on short-term securities--of 11-1/2 percent in the first quarter of 1982. We're already below that. I think we will see a significant further reduction in important rates of interest like mortgage rates if short-term rates stay where they are for a while. It may well be that some further decline in short rates is appropriate, maybe even desirable, but we need to be extremely cautious in how far we let them go because inevitably if the economy begins to recover strongly, with a combination of a relaxation of financial constraints and fiscal stimulus, the rates are going to rocket back up again.

CHAIRMAN VOLCKER. Well, I don't know how many people we can get through here, but let's try a couple more. Mr. Wallich.

MR. WALLICH. Well, in every recession there is a period where one becomes alarmed if it looks worse than one had expected. And that is the period that I think we're passing through now. But I think the staff is right that there is a foundation under the economy. It's partly the tax cut next year. I think the pent-up demand in housing, automobiles, and investment, as it gradually comes alive, will prevent a very deep drop. So, I think concern of a very severe recession isn't justified. If the economy is worse than it seemed a few months ago, so is the inflation outlook, or at least it hasn't improved.

If I may go back for a moment to the targeting problem that Larry Roos raised, the way I understand this is that the Committee sets the money supply path and the borrowing assumption. The staff derives from that a total reserves path and a nonborrowed reserves path given the borrowing assumption [and] we then target the nonborrowed. And a change in the nonborrowed [path] would simply amount to going back to total reserves targeting. A change in the nonborrowed [path] is the analogue of a discount rate change. It's a major decision and it should be made by the Committee, not just made routinely because we're not hitting the money supply target. The same could be said about changing the total reserves target. That too, it seems to me, can miscarry as a result of excess reserves building up or being drawn down, and the target should not be changed without a Committee decision.

On the aggregates, I share what has been said about M1-B. It's not a sacred number; it's a very profane number. It has been misspecified. There's a member of the Shadow Open Market Committee in New York who has an adjusted M1-B that is growing at a 10 or 12 percent annual rate. All he does is put in 50 percent of money market mutual funds and overnight Eurodollars and RPs. You can--

VICE CHAIRMAN SOLOMON. So, he's not complaining about the shortfall?

MR. WALLICH. He's not complaining. He has been complaining about our excessive reserve expansion, you see. Everybody can find something wrong with us.

MR. SCHULTZ. Who's that, Heinneman?

MR. WALLICH. Heinneman. I think that Willis is perfectly right that the bank in Ohio is in effect making it possible to have a zero balance checking account. And I think we're moving further in that direction. So, M1-B is highly suspect. Well, I guess I won't say any more on the aggregates. Just a word on interest rates: What has been said here is exactly what I think. If we stick firmly to an aggregates target, we're going to have very wide swings in short-term rates. After a while long-term rates will cease to follow this rate race and will probably remain high because people have the experience, if they ever buy bonds, of losing money as bond prices rise. If we get a V-shaped interest rate [move], we'll lose credibility. I think our credibility is really much more linked to interest rates; many millions of people are more interested in them than in the monetary aggregates in which, at least in Washington outside of three buildings not including this one, there isn't all that much faith.

MR. RICE. It depends on what phase of the cycle we're in, Henry.

MR. PARTEE. Three buildings?

MR. WALLICH. I'll tell you the addresses in a minute. There are two buildings on each side of it. I'm simply trying to say that I think we ought to aim at a saucer-type movement of interest rates. I recognize that we need to have some compromise between not completely letting go of our aggregates targets and avoiding excessive moves in interest rates. That's what we need. And in that process, we ought to avoid getting to negative real rates, as Fred said. Thank you.

CHAIRMAN VOLCKER. Well, maybe we'll go drink coffee and then get through the list. I won't blame it on you at all, Governor Wallich. It's a rather long--

[Coffee break]

CHAIRMAN VOLCKER. Let's welcome Mr. Balles.

MR. BALLES. Out our way we happen to have a big worldwide engineering outfit called Bechtel Engineering and they've just had some publicity about a brand new kind of business they're getting into. They think there's a great future in it. It's called decontamination and decommissioning from nuclear power plants.

CHAIRMAN VOLCKER. I thought they were decontaminating the M1 figure. That's what George Schultz said!

MR. BALLES. Maybe we should have George's boys take a look at our problem with the Ms and see if we can get some decontamination and decommission! I was kidding Dave Lindsey that if I were his boss, I'd give him an assignment to answer the question: "Will the real money supply please stand up?"

What I have to say today is that I'm torn between Lyle's point that we don't really know what these Ms mean anymore--and I am very sympathetic to that--versus my feeling that we want to avoid a procyclical monetary policy. As I look back over the last couple of years, we took very positive action in focusing on a gradual deceleration of monetary growth. I think that was a bold action and we had a lot of guts in letting interest rates rise to unprecedented levels in carrying that out. And I guess I would be a little uncomfortable if we weren't symmetrical on the down side. But given the recession we're now in and our guesses as to how long it will last, it wouldn't bother me to see interest rates come down somewhat further. I'm considerably influenced in that by the real risks I see of this downturn getting more serious than the staff projects, although I can't really disagree with their forecast. But the risks are there; we all know about them. There are very serious risks in the thrift industry, extremely serious recessions--and that's the only word for it--in the forest products industry and the auto industry, and there is a cost-price squeeze going on in agriculture. To the extent that we can give them some near-term relief, lower rates, it would simply head off the risks coming from those sectors of converting this present recession into a major contraction. I'm hoping that we'll avoid an actual shrinkage in the money supply such as we had in the mid-1970s. And while I certainly wouldn't want to see the extreme fluctuations in interest rates that we witnessed in 1980, I don't see very much risk of that happening in late 1981 and early 1982. Maybe I've been brainwashed by being too close to the forest products industry, but I recently appeared on a panel discussion along with Henry Reuss and they were ready to hang me in effigy, Mr. Chairman, instead of you, maybe as your proxy.

MR. SCHULTZ. That gives [unintelligible] more important. If they hang them all, that's all right.

MR. BALLES. To Henry's credit, I'm glad to say that he supported what we have been doing. He said it was necessary and was what just had to be done. That was a pleasant surprise; I didn't have to fight with him. But I'll tell you, I do have to fight with the builders and the forest products people who say they are bleeding to death or hemorrhaging. They say: What can you do for us? And do it soon because if you don't do it soon, it's going to be too late.

CHAIRMAN VOLCKER. End of story?

MR. BALLES. End of story.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Just to comment on the situation in the Chicago District, the problems, of course, have been serious all year but there certainly has been further deterioration since our last meeting. And it's clear that [just about] all of the sectors have now been affected, with very few exceptions. Turning to the auto situation, October can only be classified as a disaster. Any hope for 1981 at this point, of course, is gone. The optimism that some of them have for 1982 is significantly eroded and I think the automotive situation, therefore, is very serious. Capital expenditures in our area have been further curtailed, particularly in the automotive industry, with significant cutbacks. The Christmas shutdown schedules, which were already going to be heavy, have been extended considerably. This recession is a little different in the Midwest than other recessions have been. In the past the agricultural sector has offset the industrial sector. This time that is not the case. Because of high production, farm incomes are down and, as a result, the agricultural area is also in a very serious predicament. And that has impacts on people who manufacture products for that sector, several of whom have gotten themselves into very weakened, precarious positions. In turn, the banks that extend credit to the farms are beginning to see some slowdown in payments, and I think it is inevitable that there will be some problem loans developing among those banks as they go through a foreclosure procedure.

I am considerably more pessimistic than most with regard to the outlook for '82. I admittedly come from an area where there is a very heavy concentration of industries that have been most affected. But I am beginning to wonder if the consensus view that we will all come to work on the first of July and find that someone has turned the lights on is really going to come to pass. I think we're placing an awful lot of hope that the tax cut will produce significant benefits. I think the recovery will begin to take place as we see a permanent or more lasting impact on inflation. And until we get into the contract settlements next year, I don't think one can forecast how that will come about. I don't want to imply that any of this should indicate a significant change in policy for us. On the contrary, we continue to have the broad support of the business and financial industry and I think they would encourage us to stay with the general direction of our current policy. But my hunch is that with the economy as weak as it is rates will continue to come down and we can continue to maintain a fairly restrictive stance on the aggregates without necessarily having a negative impact on the recovery prospects. So, I would urge that we continue with this. But I do want to report that the situation in the Chicago District continues to be serious and is deteriorating.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, until the last two people talked it seemed that I was perhaps one of the few people in the room who wasn't confident that I knew what we ought to be doing. But I do sense a clear trend around the table that we're fighting last year's war, which of course is always a danger. It seems to me that the latest Maginot line is that if the federal funds rate drops below 10 percent, the economy is going to turn on the dime and shoot up rapidly. That seems to me, at least for the first half of 1982, to be highly unlikely. Quite the contrary, I think there is a risk that if we're too rigid in following this particular [policy] line, we could well end up with a much deeper recession than we're projecting. I don't have the confidence that that would be the case, but that risk is clearly there. With that background, I tried to read some of the euphemisms that Steve Axilrod is now developing for the Bluebook. I agree with him, looking at the options, that we're not going to affect the monetary growth rates in the last weeks of this year. But he talks about a more restrictive policy producing a "smoother transition to targets for 1982" and that's the euphemism that I've been trying to interpret. What I think it means--I'd like to ask Steve--is that we're going to have some very low monetary growth rates early in the year, which would be helpful in offsetting very rapid growth rates later in the year. But if we set out to produce overtly very low monetary growth rates in the first half when the economy is very weak, we could generate a larger recession than any of us would think was constructive in the situation. Have I interpreted you wrongly, Steve?

MR. AXILROD. Well, what I meant was that that alternative would reduce the odds of the funds rate going to 5 percent between now and year-end and rising back up to 15 to 20 percent early next year as an effort was made to hold the aggregates next year down to, say, in the 2-1/2 to 5-1/2 percent range tentatively adopted. That's literally what I had in mind.

MR. MORRIS. Finally, looking at the options for this meeting, two of the options call for a more restrictive policy than we announced at the last meeting. It's hard for me to envisage what economic data have come in over the past five weeks that would lead us to support a more restrictive policy than we did the last time. I could certainly buy "B" because we could still say that we're shooting for 7 percent growth through the rest of the year, which is a number we put out last time. I find it very difficult to figure out how we would explain coming out with the 5-3/4 percent target under alternative C, after having given our sanction to a 7 percent growth rate before we knew how sharp the decline in the economy was going to be. I should think that would take some doing.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I certainly would agree that the economy is soft. We even have some sense of that in the Ninth Federal Reserve District at this point. And that softness is well reflected in statistics and in business behavior and sentiment. My own personal hunch would be that the fourth quarter at least could be even softer than the staff is now suggesting. But at the same time I also sense that there is at least a residue of optimism in terms of the longer-term outlook and expectations. In part that grows out of people looking ahead to the tax cut and in part out of some of these pent-up demands that people have been talking about. There also is still some lingering hope that the inflation rate may be coming down in a meaningful way, although recent events perhaps have not worked in the direction of reinforcing that. The relevant point here is that if we want to talk about a sustained recovery--whether it starts in the second quarter or the third quarter--the sustainability quotient is going to depend on two or three critical things. One is bending down that inflation rate, including the wage side. Another is the budget situation, which hasn't even been mentioned here, and as I would look at that right now recent events seem to have worked in the direction of making it harder rather than easier to get on with the further adjustments that have to be made in that area. The other thing that is very important in connection with sustainability is that we simply have to create and maintain an environment in which some of these very serious liquidity and balance sheet strains that are all over the economy can be turned around. And achieving that turnaround under the best of circumstances is not something that is going to be done quickly or easily. It's going to take some time, which in turn implies that it will not be done in an environment in which we have these zigzag patterns of interest rates and these zigzag patterns of economic activity. That leads me very much in the direction that Governor Gramley suggested. And fundamentally it leaves me with the view that we ought to be proceeding slowly and deliberately with respect to this interest rate situation, even though I, too, obviously would conclude that there is some further latitude that can be constructively used here. But I think we have to be cautious and we have to try to avoid some of the problems of the past as we try to walk this very thin line.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Some of my concerns have already been expressed. I have a strong feeling that we're monetarists when the economy is expanding and we're interest rate targeters when it begins to collapse. If we move in and put a floor on the interest rate, which is what it sounds like around here, we'll be in real trouble. We haven't kept up with what we said we were going to do. I think there is still latitude to lower interest rates from where they are now. This staff forecast has a bottom rate on mortgages of 16-1/2 percent; that doesn't speak of any revival in the housing market next year. I think we can move it down. I agree with Lyle that we have let interest rates swing both too high and too low. Or rather we let them swing too high; I have seen very little evidence of their swinging too low at this point. I think we will probably want to pay more attention on the high side as well as on the low side in the next cycle. There's also a tendency to be very unconcerned when rates rise and then to sit and agonize for weeks about lowering them. We did that last summer and a few other times on the discount rate. It seems to me that we should be symmetrical and not try to fudge or change our philosophical point of view as we go along.

If you look at this forecast--and we have had a lot of surprises in the forecast on a quarterly basis over the past three years--it takes until the end of 1982 for real GNP to get back to where it was at the beginning of 1980. Now, that's a very, very slow-growing economy; and although there have been lots of ups and downs, we end up at the end of 1982 with an 8.8 percent unemployment rate for three solid quarters. That is not my definition of a reviving economy. And we have 8.8 percent [unemployment] projected primarily because interest rates are assumed to rise next year. When an economy is growing as little as this one is projected to grow with no impact on interest rates, some policy parameter is wrong. And this is even after a very large tax cut at midyear. We're not talking about an exuberant economy next year anyway; we're talking about an economy that is just barely keeping its head above water. If we then come down and set a floor on interest rates at 12-1/2 percent, we're going to end up like the supply siders did with the Stockman article; somebody is going to notice that the emperor doesn't have any clothes on and that we aren't accomplishing anything. Our inflation rates for the past three years have been 9.7, 9.8, and 9.4 percent and this is after three years of monetary restraint. Every time we think we're going to get a dip in the inflation rate, something comes along and [drives] it back up again. I think we should become increasingly concerned about the rate of real growth in this economy and do what we can on inflation. But [we also need to] realize that we don't have complete control and that we could do extreme harm if the economy continues to run at these very low levels of real utilization.

VICE CHAIRMAN SOLOMON. Well, that's forthright, anyway.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I have to align myself with those who think that the downturn is apt to be more serious than the staff has suggested. With a sharp deceleration in M1-B growth and the very high real interest rates here in the summer and the point that Willis Winn made that there seem to be a lot of [potential] bankruptcies--which many of our contacts are telling us will surface pretty soon--the downturn may be somewhat greater than the staff is projecting. By the same token, I'm somewhat encouraged by the reaction of some of the labor unions in the softening economy and [by the fact that] the money supply has been kept under good control. So, I would be a little more optimistic about how much we might be able to do in the way of containing inflation.

Now, when we get to the policy issue, I think there are two clear alternatives here. Everyone recognizes that we can't do much about the aggregates issue [this year]. But what we do will make some difference for next year. Most people have focused on the first choice, the desirability of maintaining our credibility by not appearing to have thrown in the towel by overreacting and letting interest rates come down too fast. But that deals with only one of the two credibility problems we have. That one relates to the belief on the part of a lot of people that generally we've erred on the side of ease [in the past]. But there's another credibility problem and that is that we haven't had a very good record of hitting our targets. And that is the one that impresses me more. So, I'd like to focus on the risk that the continuation of the shortfall in M1-B might worsen the recession and thereby impede our efforts to reduce inflation over the longer run. If this downturn is really serious, the pressures are going to be pretty unbelievable for us to ease later on. So, I would favor this second course of action. And if we do follow that, it's certainly likely that we're going to have to let rates fall significantly. I don't know how far and no one else does. But I don't think the market would necessarily conclude that we have thrown in the towel if this is the path that we follow, so long as M1-B is not moving above what we set as our long-run target. So, that's the way I would like to go. I'm well aware of the limitations of M1-B; but even with its imperfections, I believe it's a better target than anything else we have. And that preference of mine has been strengthened by the considerable weakness we've had in the economy following the weakness in M1-B. We've had strong M2 growth and yet the economy has weakened pretty considerably. So, my preference is for alternative A, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would like to align myself with comments made earlier by Governor Schultz and Governor Gramley. It seems clear to me that the weakness in the economy that we're experiencing now is something that we've been looking forward to. We've achieved it and we hope it doesn't go any deeper. But it's a point at which, if we make a mistake with regard to interest rate levels, in my judgment our credibility will indeed be in jeopardy. Let me just make one other observation. For those who have commented about achieving an M1 growth represented by alternatives A, B, or C, I'd like to observe that we are talking about only a two-month period remaining in this year. I believe Frank Morris spoke of adopting "B" or "C," which are somewhat more restrictive than what we adopted at the last meeting. At that meeting we were looking at a three-month period, and the incoming evidence suggests that we cannot achieve what we set out to do in September or October. To try to do so in the remaining 6 weeks of this period would not be my prescription.

I think the focus should now be on the interest rate level; to moderate the interest rate reductions to smooth the transition into the first quarter of 1982 is important. I would also observe that the interest rate levels have been reduced rather significantly over the last 60 days; the lagged effects of those interest rate reductions are not clear, but they are significant. Let me remind you that as of the first of September, for example, the federal funds rate was averaging close to 16-3/4 percent; it's now at 13-1/4 percent, I believe Peter said, and rates on short-term governments have had an even further reduction. We don't know what the effects of this will be but they should be positive on the economy. As a result, just to turn loose and let interest rates continue to fall to achieve an aggregate growth target for the year over the remaining part of the year is not what I would prefer.

I would suggest a prescription of alternative C with an 11 to 16 percent federal funds range, a borrowing level in the neighborhood of what it is now, which I understand is about $350 million. However, to avoid the possibility that things might turn around and we would get much stronger growth in the aggregates than was forecast in the Bluebook, I'd like to suggest a change in the language of the directive. I'd say growth of 5 percent from September to December, as suggested by alternative C, "or somewhat higher," thus accepting higher growth if it occurs. I think the [chances] are that it will not be that high. But if it is that high, in view of the past record over 1981 we should accept it for these last two months without moving interest rates back up.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. If I were to express a preference among the three alternatives, I'd lean toward "A" or "B." But, as has been stated before, this decision is a very short-run decision. If what has happened in the past few months were to happen over the next two months, regardless of whether we choose "A," "B," or "C," we probably won't hit our choice right on the nose. So, I don't think what we do today is all that important. I do think, though, that what we do in our next two meetings is extremely important, and I'd like very briefly to address myself to a couple of concerns that I've had as I have listened to the discussion today.

First of all, regardless of the terminology that tends sometimes to disguise it, there is significant sentiment being expressed that we should revert to paying primary attention to interest rate stabilization. That was our practice prior to October 1979. This [view] is apparently based on some very real skepticism as to whether the aggregates are meaningful, whether they're definable, and whether they're controllable. I've heard a lot of people say that M1-B should be discarded because M2 somehow or other fits somewhat better today. I would remind those people that if M2 were really the meaningful aggregate and were growing as strongly as it has, we wouldn't be faced with a problem of the slow economy and recessionary characteristics that we're facing today.

However, I think there's an even more fundamental concern as we look ahead and that is the decision as to whether or not we ought to revert to our former practices. We know that our mission is to try to achieve reasonable price stability and to achieve steady economic growth. As some of you have said, it's not desirable to have [large] variations or ups and downs in interest rates. Well, I would remind you that prior to October of 1979 we spent precious hours discussing whether or not interest rates should be set 1 point or 1/2 point higher or lower. We attempted to conduct monetary policy by targeting on interest rates. And I would remind you, unless I misread what happened, that when we convened on October 6, 1979, after many years of carefully attempting to guide the ship by controlling interest rates, we were very concerned that we had seen significant fluctuations, cyclical and other types of fluctuations, in economic activity and we also were experiencing shockingly high rates of inflation.

Now, even though we may assume that our efforts to control the aggregates have not been as fruitful as we might have wanted, if you review what has happened since 1979, I think you would conclude that there is some relationship between the behavior of the aggregates and price stability, lagged, and economic growth. Compare the times when the aggregates grew above our ranges and see whether or not there was a stimulative effect on the economy a few months afterwards. Indeed, [consider] whether the slow growth we've had isn't reflected somewhat in the present weakness in economic output that we're experiencing. So, I would conclude my remarks merely by saying that if we decide that [what we did in] October '79 was wrong, then let's tell the world that we're going to go back to where we were prior to October '79. I would submit that if we do that, we would have the most violent upward movement in the interest rate pattern imaginable and our credibility would be forever destroyed, because our Chairman has done a very effective job of convincing people that we are determined to pursue this new course. But if we start equivocating, if we start waffling, I think we're in for severe problems. These are some of the issues that perhaps we will discuss in the next couple of meetings. Certainly today there are a lot of people who would say: "Let's pitch out [the decision of] October '79 and go back to interest rate stabilization."

MR. SCHULTZ. I don't think I heard anybody at the table say that.

VICE CHAIRMAN SOLOMON. Well, [Roger] just said it.

MS. TEETERS. It's implicit in setting a floor on interest rates.

MR. GUFFEY. Not at all.

MR. SCHULTZ. I didn't think so. I don't believe you'd get anybody to vote for that.

MR. ROOS. Fred, it was certainly implied when people said we have to avoid upward and downward gyrations in interest rates which, of course, contradicts any ability to control the aggregates. At least I think [it does].

CHAIRMAN VOLCKER. I think it's fair to say there are differences in emphasis.

MR. SCHULTZ. That may be; I agree with that. But I don't think anybody wants to--

VICE CHAIRMAN SOLOMON. I think it's also fair to say that equivocation is in the eye of the beholder.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I didn't say anything about my preferences on the alternatives before. I agree almost totally with what Frank Morris had to say. I would choose alternative B. I don't know that it's all that important to get a 7 percent increase in M1-B in November and December, but I certainly would like to have an appreciable increase. As you know, we've chosen 7 percent since July. And we've only had 7 percent in one month of the months that have gone by. So, I'm not really sure what it means when I say I'd like the 7 percent alternative because it may not be that at all. But I guess what I'm saying is that if M-1B growth turns out to be significantly below 7 percent--and significantly below I would define as being below 5 percent--I would assume that we would not regard the federal funds rate range as being a [constraint] that would stop [us from] trying to get more growth. So, I'm prepared to accept 10 to 15 percent on the federal funds rate range, as stated in the directive. But if the aggregates continue as weak as they have been--not what the staff is projecting, but what they have been--I would want us to break below 10 percent on the funds rate.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I think the split among us is sharper today than it has been in a long time. It turns, really, on the question of how much importance one gives to a moderate, orderly decline in interest rates as against a more rapid drop. I'm concerned about the reaction in the bond markets if there were a rapid drop in the fed funds rate. There could be a very negative reaction and this moderate decline that we've been seeing--and yields in bond markets have the best chance of influencing and bringing down mortgage rates--could be cut off very abruptly if markets see a precipitous decline in short-term money rates. I think it's true that many of us here are more concerned about declines in [real] interest rates when they threaten to drop too precipitously, in our judgment, and become negative. But I don't think there's anything inherently immoral, let alone unaesthetic, Nancy, about asymmetry. The--

MR. PARTEE. It creates a very poor economy.

VICE CHAIRMAN SOLOMON. Well, I'm not too sure; it depends on where our priorities are.

MS. TEETERS. That's not the argument I heard when they were going up, either.

VICE CHAIRMAN SOLOMON. I've never argued that there has to be a mechanistic asymmetry in conducting a complicated monetary policy. In any case it, I align myself with Fred Schultz, Lyle

Gramley, Roger Guffey, and although he's somewhat elliptical, I think Jerry Corrigan, Henry, and a few others.

MR. CORRIGAN. I didn't say anything--

MR. SCHULTZ. You're just elliptical looking, Jerry!

MR. CORRIGAN. Well, I've always been elliptical looking!

VICE CHAIRMAN SOLOMON. I would argue that we should have something close to alternative C, say 6 percent, for October to December.

MR. PARTEE. That's "B."

VICE CHAIRMAN SOLOMON. No.

MR. PARTEE. Oh, for the two months, October--

VICE CHAIRMAN SOLOMON. Or 5 percent for September to December, if you want to use that, but I think it would be silly to formulate it that way in the directive. Secondly, I also think a funds rate range of 11 to 16 percent makes sense because we've had this sharp decline of about 300 basis points in the fed funds rate. And if it were to drop to 11 percent from 13-1/4 percent within the remaining six weeks of this year, that's a very substantial drop. I would find it surprising that people would want to see it drop faster than from 13-1/4 to 11 percent within a 6-week period. I believe that the recession will continue into early next year and that there will be further pressures to continue the downward [trend] of rates, which I think we have to accept. My only point is that [the decline] be moderate and orderly or we will have a perverse reaction in the bond market. Now, I would assume we would start with an initial borrowing of $350 or $400 million. I also would agree that if growth in the money supply comes in higher, we could accept that. The disadvantage of targeting higher monetary growth is that there's a greater likelihood that we will get a decline in interest rates at the front end of the period at a much more rapid rate, instead of spreading it out over a period of months in a more moderate way.

CHAIRMAN VOLCKER. Before we have a lot of debate back and forth, I think we ought to get through our list here with Mr. Boykin. Then we will attempt to draw all these conflicting stands into happy harmony.

MR. BOYKIN. I've been sitting here, Mr. Chairman, trying to be sure I had the strength of my convictions. If I can figure out what my convictions are, maybe I'll have the strength! I would like to comment very briefly on the economy down our way, particularly since I have a slightly different story to tell this time around. I think there has been a decided change in attitudes in the Eleventh District over the last six weeks. We see weakness starting to spread in our area. Of course, like the rest of the nation, retail sales, autos, and housing have been weak for some time. We are starting to see some increased layoffs in the manufacturing area--in the aircraft and the electronics industries. Also, there are some early signs of possible weakness in the energy industry. The drilling boom seems to be slowing a little. I'm told that one can actually see a few rigs stacked in the yards, and that has not been the case for quite some time, although the demand for the deep offshore rigs remains strong. We have had unusually heavy rains, particularly in the north central Texas area, and that is going to cause quite a bit of crop loss, particularly in cotton and wheat. People are estimating a loss of about $25 million in that area. Also, we're beginning to hear concerns expressed about the possibility of over-building in the commercial area, particularly in the Houston and Dallas markets. As far as the staff's outlook on the economy, that is about the way I would see it. It's a reasonable outlook and it's consistent with what I'm hearing.

On the policy side, a very sharp decline in [the federal funds rate] right now would cause me a lot of concern, particularly for the implication for the long-term rates. [As for] credibility and perceptions, I think there's more likelihood of serious criticism from the majority of people on the interest rate side rather than on not meeting the stated targets. Steve's explanation of how alternative C was constructed and what it's intended to do I find very persuasive, and I'll line up on alternative C.

CHAIRMAN VOLCKER. Well, let me try to summarize a bit. There are some differences in emphasis, but I'm not sure--we'll find out--whether they're as great as they appear to be.

Oh, let me ask you a question, a side issue, on this energy business. You say there are some early signs of a much [less] rapid increase at the very least. I've heard the view expressed that a lot of the activity currently in the energy area is based upon an assumption that the oil price is going to be--I'm trying to remember the figure now--$80 or $90 a barrel in the 1990s. And then if that assumption is a disappointment--

MR. WALLICH. In real terms? In constant dollars?

MR. PARTEE. In nominal terms.

CHAIRMAN VOLCKER. In nominal terms. Presumably, they're doing the drilling. It isn't all that clear to me, but the point was that the price [assumption] was high enough that a lot of people might begin questioning it. Do you have that feeling?

MR. BOYKIN. Yes, that does seem awfully high. On the other hand, we get a few scattered reports of some shutting in going on, just not producing. They know it's there and ready to go but are holding back because of the supply side.

CHAIRMAN VOLCKER. A price of $90 a barrel, if it's in nominal terms, isn't even an increase in real terms if these 10 percent inflation forecasts are correct.

MR. SCHULTZ. May I ask a question in line with that? As you pointed out, most of the drilling going on is deep drilling.

MR. BOYKIN. Yes.

MR. SCHULTZ. That's natural gas drilling?

MR. BOYKIN. Yes.

MR. SCHULTZ. Is there any oil at those [deep] levels? Are they doing a lot of betting on natural gas decontrol? Is that [a major factor]?

MR. BOYKIN. Yes, I think it almost has to be, Fred. We heard a report, and the Chairman heard it also, of some deep wells down in the Laredo area where [it cost] about $4 million to drill one well and $8 million to drill another. As the director who was reporting on that said, somebody has to be thinking something that he was not aware of. I would think they have to be betting on decontrol.

CHAIRMAN VOLCKER. Well, I think there are a lot of assumptions in the gas business that the price of gas is going to be $12 or more a cubic--

MR. SCHULTZ. MCO.

CHAIRMAN VOLCKER. Foot or MCO or a thousand cubic feet, whatever it is.

MR. SCHULTZ. Thousand cubic feet.

CHAIRMAN VOLCKER. Not in the 1990s but in 1985 or 1984.

VICE CHAIRMAN SOLOMON. Even under the present law, newly discovered natural gas will be fully decontrolled by 1985.

MR. GUFFEY. It is today, I believe, for newly discovered. But they have to compete with the old gas.

MR. BOYKIN. But isn't there still a question of whether it's interstate or intrastate?

MR. GUFFEY. It's my impression that that's not true. Any new gas is--

MR. SCHULTZ. If it's below 15,000 feet, but it's almost all--

MR. BOYKIN. We were told the other day by one energy economist that there are 17 different price levels for gas, if you can believe that. It's based on all kinds of combinations, as you say: the depth, the age, whether it's going interstate or intrastate. But there are 17 different price brackets.

SPEAKER(?). Is it also based on how it smells?

VICE CHAIRMAN SOLOMON. The cheating must be enormous.

CHAIRMAN VOLCKER. I'm not even sure what that director was assuming with regard to $80 to $90 a barrel. I think it probably was in real terms.

MR. GRAMLEY. Well, in nominal terms, 10 percent--

CHAIRMAN VOLCKER. In ten years, 10 percent is nothing. That's right. He must have been talking in real terms.

MR. PARTEE. [Unintelligible] is 7 years.

CHAIRMAN VOLCKER. Let me just make one point. We did an awful lot of talking about M1. It has been pointed out by a couple of people that M2 has been in the directive as well and that somehow M2 wasn't as reliable because [its relatively rapid growth implied] we wouldn't have had a recession. I'm not so sure about that. We thought the M2 range was very tough and restrictive when we adopted it. We thought we'd be at the higher end of the range if we were within it at all. I guess the velocity of M2 hasn't changed much, has it? This year the assumption was right on the button. There wasn't much [change in] velocity. Anyhow, that's a side comment.

While I listened to all the comments around the table, I have the impression that there are some problems that only time will solve and I think we have one of those. I don't think we should suffer from an excessive hubris that whatever we do is going to produce a nice, neat answer to our problems. A sour view of business is rather common around the table. I didn't hear anybody not express that. And I heard quite a few views that, when one has to look at an uncertain world, the staff's projections are as good as any. There was a certain amount of talk about the risks on one side of [the economy] getting worse. Let's talk about the risks on the other side of it being better. I think they exist, too. There's certainly a view around--maybe the most common view--that the economy may not perform very well in the short run, but we're going to have one hell of a recovery in the second half of the year. A lot of people are probably operating on that basis. I'm not saying that's the right view, but it is a view that a lot of people hold. And that probably has some implications for activity. Currently, there is a risk of some cumulative difficulty, complicated not just by normal kinds of cumulative difficulties in recessions but by financial problems that we can't see very clearly but may be there. We have an uneasy feeling they may be there.

I don't think we can put a lot of money, speaking for myself, on any of these particular projections. And while I agree that the staff view is as logical as any, the range of dispersion around any forecast, I suspect, is going to be pretty high. In any event, we've got sour business in the very short run. We still have high inflation expectations. I suspect they may be improving a little, but I get the same kind of reports that Mr. Boehne commented on, and I think inflationary expectations are going to be very sluggish to change. Part of the nature of our problem is that the business picture can move much faster up or down. At the moment it is down. Then some other things may change, such as inflation and inflationary expectations and long-term interest rates in particular after all those markets have gone through. That in itself means we're in a kind of no-win situation. If we deal with the inflation and long-term interest rate problem, we cannot deal with the business problem; or if we deal with the business problem aggressively, we can't deal with the long-run inflation, long-term interest rate problem, I suspect. There is no way we can do it with the limited tools that we have. We can get more relaxed about the whole inflation issue; I'm not sure that would help. But I'm not ready to go with, as Nancy was suggesting, a basically new approach. I'm not going to suggest that at the moment and [that is] a little outside the range of consensus for this meeting anyway.

How favorably this will develop depends not only on all these uncertainties about business that we can't resolve, but on how fast people become more confident that we can get on an orderly long-term path. I think a lot depends upon wages. I alternatively get hopeful and discouraged about that depending upon the latest report. In fact, we don't know much. But in terms of financial dimensions, it does seem to me, in a sense, that the key is how to get long-term market rates down and bank rates down. Those are the rates that are going to be most important for the economy. But it's not really just a problem of getting them down; it's a problem of getting them down so they stay down. I don't think any short-term relief on interest rates is going to mean a thing, if they begin bouncing up again pretty quickly or with any possibility of that happening. And I'm not thinking primarily in the political terms that Fred Schultz mentioned. Our basic problem is how we stimulate the economy. That may be expressed more happily at the moment as avoiding an excessive decline, without the threat of interest rates moving right up again as soon as the economy levels off and shows some signs of life. I think there is a real possibility of a turnaround at some point; how fast depends partly on what we do. But at this second--to exaggerate just a bit--we're going to run into a stone wall, assuming the kind of monetary targets we have for next year. We will find markets very sensitive to an increase in the economy or an increase in the aggregates, which normally accompanies an increase in the economy. And without either enough experience with declining inflation or enough confidence in the future generally [unintelligible] movement, as I see it at the moment, from being very abrupt.

If we have a sizable turnaround in the economy in a hurry--expectations of a buoyant economy and expectations of higher interest rates or whatever--I don't think we're going to have much time for all those balance sheet adjustments and changes in behavior that are necessary to restore more balance to the financial system. And we'll be up against the same dilemma this year that we had last year. I don't know how indefinitely one can go into the future. There is a question of how confident people feel about the outlook for inflation.

Not much has been said about the budget. The question of the upturn in interest rates after whatever downturn we have is going to be importantly affected by what people think the budgetary outlook is. That doesn't look very good at the moment. But I must say it's also affected, at least as importantly, by what people judge our own behavior will be--whether we're going to react or come out of the shoot in a hurry the next time the money supply shows a little bulge on the up side, because that's the way they are sensitized to think we're going to behave. And so long as the monetary growth rate is low, they are sensitized to think interest rates will go down, and that's what is happening. In a way, if we want to get interest rates lower, the best thing that could happen is to have the monetary aggregates continue to look low, because the minute they begin to look high, I think that will be the end of the interest rate decline, at least in the long-term market. In the space of some months, I doubt if that can be avoided. If we were successful at the moment in getting a big increase in the money supply, I would not bet very much on long-term rates coming down--for a good many months in any event. I don't particularly think that's going to happen.

There's great difficulty in knowing what the money supply is at the moment. That has been adequately discussed. I would just make one other general comment in reaction to what some people have said. I do think that we've had too much interest rate instability and too much exchange rate instability. If this persists into the future in the range that has occurred in the past couple of years, at some point we're going to shake these financial markets apart so much that nobody will know where in the world they stand and a long-term investment will be three days. That's not very encouraging, particularly with regard to the long-term interest rate problem that we have.

Something occurred to me during the discussion when Frank Morris accused--if that's the right word--Steve Axilrod of saying something I don't think was in Steve's mind. But let me say that I don't think it's so bad if it was in Steve's mind, because it's somewhat in my mind. We get a natural force toward moderation of monetary growth when we get downward forces in the economy. We get a certain natural push upwards on the money supply when the economy is beginning to expand. And if we literally [evened off] the money supply through those demand forces, we'd have a violent change in interest rates. I don't see that there's any way to avoid it. Let me come back to Lyle's point about how violent a change in interest rates we want and whether we really are achieving anything. I don't think that calls into question in a fundamental way the trend of monetary growth over time. What it does call into question is how hard we should fight against essentially cyclical movements in demand forces on the money supply. When we get these waves in the money supply, we have lots of problems explaining ourselves to the iron-clad monetarists in the part of the market that's [persuaded] by that kind of argument. But I don't think it is or fundamentally has to be interpreted as a departure from the general idea that we've got to get a lower trend. It's not a question of how much cyclical amplitude we allow around the trend. We don't allow any cyclical amplitude that's going to raise questions among the questioners. But one has to ask what the lesser evil is.

In any event, getting down to the nub of what we have to decide, let me try some verbal formulations. We may have a problem writing a directive that people can understand and agree with. But I'm not sure--we'll find out--how far apart we really are. I think what we're debating is the aggressiveness, in a sense, with which we move to push the money supply up or deal with weakness, if that's what we're going to have. I don't think I really hear anybody saying that we shouldn't move in the direction of easing bank reserve positions and be prepared to see some decline in interest rates if the money supply is on the weak side. I don't think I hear anybody saying that if the money supply took a little jump, we should be sitting here resisting it in any sense. Having said all that, we need to quantify what we mean and how we express it. It's almost easier to talk in terms of the operational variables rather than the targets themselves, recognizing that the actual movement in the money supply over the next few weeks probably is not going to be affected much by what we do and we'll have to take the figures as they come. Some consistency in our operations as we set them now--not knowing what those money supply figures are going to be--with further declines in interest rates of a moderate character doesn't bother me. I think that's probably appropriate in all the circumstances. I would think that means something like a $350 million figure for borrowing or $400 million, or someplace in that area. We'd be prepared to move down on that if the money supply is weak and not prepared to move up on it if the money supply is strong unless [it's extremely strong]. But I can't conceive of it being strong enough so that we'd want to move [borrowing] up, frankly. But we would have to be prepared, I think, to move it down somewhat if the money supply remained weak.

Just how to define weakness is going to be an issue. We have had the pattern recently of a 5-point band in the federal funds rate range. It's an artificial contrivance in many ways at best because if we put a 5-point band on any of these numbers I'm not sure anybody sitting here would want to think of the federal funds rate going up to 15 or 16 percent as some of these [Bluebook alternatives show]. In current circumstances the rate probably is not going to go up at all significantly from where it is for any length of time. It is slightly over 13 percent now. I suppose, on the convention we've used in the past, that would make the range 10-1/2 or 11 percent to 16 percent or someplace in that area; but the upper part of that range isn't very relevant. I'm sure that this feeling would not be unanimous, but there is a considerable amount of feeling that we'd want to take a very hard look at this if the rate got down toward the lower end of the range, as it well could. It is probably not apt to do that unless [the Board] reduces the discount rate in the near term. I think the discount rate is clearly going to be in question during this period and should be in question in terms of a downward movement. I think we would assume that that move might well come sometime before the next meeting, unless there is quite a change in the business picture. When one thinks in those terms, we could begin getting down toward those funds rates quite easily but probably after a period of time. The discount rate isn't going to be moved right away. Now, as to how to formulate the actual directive, I think basically we have two choices: We can put in a relatively low number and say we're not bothered if it's higher; or we can put in a relatively high number and say we're not bothered if it's lower. Maybe we could have a little more discussion of those options.

MR. SCHULTZ. Well, I've said my piece on the interest rate issue. I'm not bothered by the fed funds rate getting down below 10 percent, but not between now and the next meeting. I would go with the idea of a target and then say "or somewhat lower." My choice would be alternative B with initial borrowing at $350 million and a federal funds range of 11 to 16 percent. It's basically "B," but with a different funds rate [range]. After all, that's a consultation point. I think we ought to consult if it gets [to 11 percent]; remember, the next FOMC meeting is only 5 weeks away, so it's a very short period of time. I suspect, as I said yesterday, that we're going to have to move that basic discount rate pretty soon. And I would have some concern about the rate going [down] faster than that, which is why I say 11 to 16 percent. I'd have some concern about the borrowing getting down any lower than $200 million during this period of time.

MR. PARTEE. Well, I buy the $350 million and I buy the "B" [specifications] but I would want the funds rate at 10 to 15 percent. I certainly can't imagine it over 15 percent, and I would want us to consult very promptly if 10 percent is going to hold us up and we would not have a good growth in the money supply.

MR. SCHULTZ. Incidentally, I'd be willing to go 11 percent with 15 percent on the top end; the only problem is that it's only a 4-point range. I don't think we're going to hit that [upper limit] anyway.

MR. PARTEE. No.

CHAIRMAN VOLCKER. I had Steve draft a couple of alternative directives. Let me read them to make sure I understand them first. Well, let me just try this on you. The concept is simple enough; the language can be worked on, obviously. One option follows a practice we have used at least once and maybe more than once, and I think it's a good practice unless we have to deviate from it because it doesn't sound like so much fine-tuning. It starts with exactly the same directive that we had at the last meeting, but it puts it in the past tense, so to speak. It says that at the previous meeting we decided on 7 percent and 10 percent, [respectively as the quarterly targets for M1-B and M2]. Then "In reviewing these quarterly targets, the Committee felt that shortfalls in growth would be acceptable if they are generally consistent with phasing into the tentative monetary growth targets set for 1982 and as they may occur in the context of declining interest rates." Then it goes on with the federal funds range. So, it says in effect: This is the target we had set for the quarter; we recognize we set it; it looks like we're low and we'll accept the shortfall provided interest rates are declining; and we're not too unhappy with the shortfall in the light of phasing into next year.

The other option, presumably, would be consistent with doing something like "C." We'd put in those numbers for the next two months, but say a somewhat higher growth rate would be acceptable as consistent with the quarterly target set at the previous meeting and just repeat the targets of the previous meeting. That doesn't say anything about--. What I was looking for was whether there's any interest rate allusion in that one. There is not, I guess. But in that one we put in the low number and say we're perfectly happy to raise it to where we set it at the last meeting. The other says that what we said at the last meeting is okay, but we're happy with a shortfall [in money growth] if interest rates are declining, and it's logical for moving into next year anyway.

MR. PARTEE. What if you're not happy with a shortfall?

CHAIRMAN VOLCKER. If you're not happy with any shortfall, you're not going to be happy with either of these formulations because they both are low.

MR. PARTEE. That's my reaction.

MS. TEETERS. What if you're not happy with next year's targets?

CHAIRMAN VOLCKER. Well, if you really want it much higher--if you want a 7 percent target next year--then you wouldn't buy this one. But I think all it's saying basically is that the number is something less than 7 percent. It's more consistent with what we're tentatively thinking about next year than 7 percent.

MR. RICE. Why does 7 percent for the next [5] weeks mean that we favor 7 percent growth next year?

CHAIRMAN VOLCKER. It doesn't.

MR. RICE. I didn't think so.

CHAIRMAN VOLCKER. It doesn't say we favor 7 percent growth next year. What it says is that if we have 7 percent growth--. Well, the thought expressed around the table by a number of people was that if we push hard for large growth now, then we will have to slow it down next year, and that may be undesirable.

MR. PARTEE. We will have a lot of shortfall to make up, though, when we get into next year.

MR. RICE. Well, we still have--

MR. AXILROD. It may not be as clear as I was trying to make it. The 7 percent was for the quarter.

CHAIRMAN VOLCKER. Yes, that's for the quarter. This is just repeating what we said at the last meeting.

MR. AXILROD. Last meeting we said we'd like the quarter to be this way. The operative sentence says we're going to accept the shortfall from that so long as interest rates are declining, which could mean that 7 percent over the next two months would be a shortfall from the 7 percent for the quarter. It wouldn't preclude a vote from a Committee member who favored that.

MR. RICE. That's right.

MR. PARTEE. But it's open [ended]. It could get to zero with interest rates declining. It still seems to me a test of the directive.

MR. AXILROD. Well, I was trying to say that you wouldn't really like it much below where you were going into next year.

VICE CHAIRMAN SOLOMON. We have a smaller--

MR. PARTEE. What is "some shortfall"?

VICE CHAIRMAN SOLOMON. Chuck, we have to give some verbal guidance on how much of a shortfall is acceptable.

MR. PARTEE. Well, we better have it in the directive because it sounds as if it could be zero or minus 10 percent as long as interest rates were declining.

MR. BLACK. That's why a shortfall--

CHAIRMAN VOLCKER. We've used language of this sort before, Chuck. That's ridiculous, if I may say so.

MR. PARTEE. It's not ridiculous because we're 7 percentage points off our expectations on average for the last six months.

CHAIRMAN VOLCKER. We are not when you take account of M2. That's just wrong.

MR. PARTEE. Well, I thought M2 was below--

CHAIRMAN VOLCKER. M2 is still in this directive. M2, in fact, is currently projected to be on target.

VICE CHAIRMAN SOLOMON. I agree with Chuck, but for different reasons. My concern is that the markets will assume that we mean only a very modest shortfall if we say a shortfall will be accepted. Secondly, I'm concerned about the [possible] interpretation of the caveat about declining rates. We'd have to say at least an "orderly" decline of rates, or something like that, which doesn't imply that we're pushing gung-ho for that. I think on balance there's less danger of misinterpretation if we use the other alternative--if we put in something like alternative C and say we will accept something lower than that.

CHAIRMAN VOLCKER. What are you going to do in your conception if growth comes in less than alternative C?

VICE CHAIRMAN SOLOMON. Then the fed funds rate is going to go [down] until we change it.

MR. CORRIGAN. I have been thinking about alternative directive formulations this morning, too. I must say I struck out because of the very problems we're running into here already. My preference at this point would be to have the directive state the aggregate numbers for October to December that are in alternative C with the language "or somewhat higher" with borrowings at $350 to $400 million. I could accept combining that formulation with a federal funds rate of 10 to 15 percent, simply because I think it's going to be hard to get the aggregates specifications even in alternative C, given the economy. But I do think that kind of language formulation, notwithstanding Frank Morris's concerns, is more prudent and safer in terms of people understanding what we're doing. And obviously, if the aggregates were soft, we still would have the opportunity to use the consultation procedure to make further judgments as we go along.

MR. FORD. I had Frank down for "A." Are you saying you agree with Frank?

MR. CORRIGAN. No. I said notwithstanding his concern about how to explain why we're now at 5-3/4 percent instead of 7 percent. I think that can be dealt with. No, I'm talking about "C" or somewhat higher and, as I said, I could go with 10 to 15 percent for the funds rate band simply because I think it's going to be hard to hit any of these things.

MR. GUFFEY. I would join in that, except that for the federal funds band I would prescribe 11 to 16 percent simply because of the shortness of the horizon; we're [only] looking at the next [5] weeks. If the funds rate drops to the tune of another 2-1/4 points, that is close to being a precipitous drop over the last three months.

MR. CORRIGAN. That's my preference, too. I'm saying I could live with it.

MR. GUFFEY. Oh, I see.

MR. GRAMLEY. I would agree with Roger, and I would prefer the 11 to 16 percent. I do think the alternative formulation, the first one that you read, is awfully fuzzy. It's sufficiently fuzzy that I don't know whether anybody would know exactly what we're talking about.

CHAIRMAN VOLCKER. Unlike the other one?

MR. PARTEE. Well, I would prefer alternative B just as it is written. I don't know how many others feel that way.

MS. TEETERS. I would prefer alternative B with the 10 to 15 percent. I think there is a real problem of perception in that it looks as if we've tightened monetary policy at the wrong time if we go with the 5-3/4 percent target for M1-B.

MR. RICE. I would prefer to see alternative A, but I'd be willing to accept the money growth figures for alternative B with the borrowing at $200 million and a federal funds band from 9 to 14 percent.

MR. PARTEE. $200 million is awfully low as a start for borrowing.

MR. RICE. I'm willing to do that.

MR. BOEHNE. I prefer alternative B with a funds range of 10 to 15 percent and an initial borrowing level of $350 million.

MR. BALLES. I'm concerned in formulating this directive, Mr. Chairman, that it certainly will appear odd that we have adopted the alternative C specifications at a time when we know the economy is worse. And that leads me to join those who have spoken up in favor of alternative B. It's a minimum of what I'd like to see.

MR. RICE. Mr. Chairman, no one has really [addressed] Frank Morris' point about what has happened since the last meeting to justify making our targets more [restrictive] than they were.

CHAIRMAN VOLCKER. A big decline in interest rates and a shortfall in M-1B in October.

MR. RICE. I don't think that justifies it.

MR. CORRIGAN. The shortfall in October is the easiest one in the world to--

MR. RICE. I don't think that justifies anything.

CHAIRMAN VOLCKER. I may have to agree, but you asked me what justifies it.

MR. PARTEE. I think Tony is absolutely right. We've now separated the interest rate people from the aggregates people. And it's very hard to bring them together.

MR. KEEHN. Can't we to some extent cover the problem of appearing to be tightening by commenting about moving into next year? Consistent with what you said, we could say we are positioning ourselves by this particular choice to move into the band that we will select for next year.

MS. TEETERS. That will scare the market out of its mind if you do that because they would interpret it to mean that we're heading again for the lower end of the range next year.

MR. KEEHN. No, I'd say we would be positioning ourselves to move into the band that we will select for next year.

MS. TEETERS. I don't like next year's targets; I think they're too low. I hate to commit myself to them; it gets to the point that we can't do anything about them in February. We're supposed to take a new look at them in February. This freezes us in concrete as to what we're going to do for next year's target.

MR. PARTEE. That's what you've said all along.

CHAIRMAN VOLCKER. Well, do we have any other comment?

MR. WALLICH. Well, I'm concerned mostly about the possibility of the funds rate falling below the discount rate and of very low borrowing. Then things could get out of hand and confront us with the need to keep lowering the discount rate in order to prevent that. For that reason, I would start off with a [relatively high] borrowing assumption and I would like to consult at a somewhat higher [funds rate] level on the way down. Consulting doesn't mean that one stops there. But at least at a time when much higher mobility of interest rates is a possibility, we ought to look at it earlier rather than later. So, I would go for $400 million for borrowing and 12 to 16 percent on the funds rate without any expectation that it would go to 16 percent. But neither would I like it to drop below 12 percent without talking about it.

MR. FORD. I'm concerned about the appearance of setting a goal. Maybe I have a problem with understanding the philosophy of these statements even after hearing them discussed so often. As I understand it, the philosophy when we set a target is that it is a target and we may not always achieve it. We have a problem now because we've been underachieving both the short-run and the long-run targets on one of the things we look at, M1-B. Were we to put out a directive that appears to have set tighter targets as we're facing the prospect of what may be a very serious recession, starting from a disastrously low level of economic activity in major industries such as housing and autos, we could scare the devil out of everybody by having people perceive that we're trying to be very tight. So, the concern and all the talk about how to couch this is very important. I'd be inclined to err on the side of staying with the target that we may not achieve, the one we had last time, and not narrowing the funds band again but allowing it to have a little more leeway on the down side. I'd go with something more like Emmett Rice's prescription of a

"B+" or "A-" type prescription, with a borrowing assumption of perhaps a quarter billion dollars or somewhere in that range and a wide funds rate range. If I counted right, 4 or 5 times earlier this year we set a 6-point range. Why not set a 6-point range of 9 to 15 percent, sort of centered on where we are now and allow ourselves a little more leeway?

MR. GRAMLEY. That 9 to 15 averages 12, not 13-1/4 percent.

CHAIRMAN VOLCKER. The basic problem we're dealing with is a repetitive problem. We are setting a target for the next six weeks and nothing we do here is going to affect what those numbers are over the next six weeks. We have to have a little longer perspective.

MR. FORD. You're right. There's only a difference of $2 billion in M1-B on "A," "B," and "C." It's less than the amount of change we've had on the last two Fridays.

MS. TEETERS. But that argues more for the appearance of it and that we stay with the 7 percent. I agree with you that nothing we do is going to affect what happens over the next six weeks.

MR. RICE. We all agree on that.

MR. FORD. So, the whole question is what the market [will think]. If they think we're tightening--

MR. BOEHNE. I would still stay with "C" the way it's prescribed with a borrowing assumption of $350 million.

CHAIRMAN VOLCKER. I don't know. We're not going to resolve this before lunch. I guess I come back more strongly to my gut feeling that we're better off not horsing around with the target that we set last quarter in a formal statement. But I'd clearly admit that we are prepared to see a shortfall under certain conditions. It seems to me we clearly are.

MR. FORD. And that we wouldn't be surprised.

MS. TEETERS. I think that's more like it. It's not that we're willing to see a shortfall but we expect that it's going to happen.

CHAIRMAN VOLCKER. Well, I think that's about the same as saying we're willing.

VICE CHAIRMAN SOLOMON. Maybe we should simply say there are only six weeks left to go and there's no point in--

MS. TEETERS. Is it the difference between [desiring] and accepting?

MR. MORRIS. What we do in the next 6 weeks will impact what happens to the money supply in the first quarter.

MR. BOYKIN. That's right. The world doesn't stop.

MR. BOEHNE. We buy a little more insurance that the money supply is not going to fall out of bed.

MR. CORRIGAN. The next six weeks matters, too, if we get borrowings down to whatever that frictional level is. I agree with Governor Schultz; I have a hunch that the frictional level of borrowing is higher than Steve was suggesting, although I can't be sure.

MR. AXILROD. Well, I happened to look back at the data, President Corrigan, and it might be of some interest to the Committee that in June and July of last year the level of adjustment plus seasonal borrowing--and I think the funds rate ran a little below the discount rate at times in that period--came out [in millions of dollars] at 104, 34, 127, 44, 75, 20, 121, and 145 for 8 straight weeks in June and July. So, it can run quite low. There's no guarantee, but it can run quite low.

MR. CORRIGAN. Look what happened in August and September.

MR. AXILROD. Well, borrowing sort of goes up. It doesn't give you any scope for shortfalls in required reserves because you create large excess reserves. That can happen. That's the danger.

MR. SCHULTZ. The question though, Steve, is: When we first hit that frictional level what happened to the funds rate? That's what gets me concerned. There's a point at which the drop in the funds rate gets very rapid in that kind of period.

MR. AXILROD. That's only, Governor Schultz, if this so-called frictional level, which might happen in any event, is also accompanied by a very sharp rise in excess reserves. Then the funds rate could drop very substantially.

MR. CORRIGAN. Did that happen in those weeks that you mentioned last year?

MR. AXILROD. No.

CHAIRMAN VOLCKER. Let me talk a little less theology and a little more practically at the moment. Suppose we start at $350 million as an assumption. Make the figure a rounder number and start at $400 million, Mr. Axilrod. In the ordinary course of events, you set a nonborrowed reserve path. You start it, just as an assumption, at $400 million and you will put in a growth path for M1-B. Let me give you two hypotheses for that growth path you put in for M1-B: One is 6 percent, just to keep the numbers round, which is close to "C;" and for the other extreme, say, 8-1/2 percent, or round that down. Now, if the money supply comes in around 6 percent, the borrowings would remain at $400 million or whatever the [initial] level is, if we adopt "C. Presumably, that's what would happen. If we put in the [higher] number on the basis of "A" and the money supply comes in at that same 6 percent, how much would the borrowing level go down?

MR. AXILROD. Well, roughly it would be $200 million lower on that, having started the path at--

CHAIRMAN VOLCKER. It would be $200 million lower by the latter part of December?

MR. AXILROD. Yes, I was looking at a monthly average, but it would be in that area in December. It's $2 billion divided by 10, roughly. It's not quite precise.

CHAIRMAN VOLCKER. That is the range of what we are talking about in nondiscretionary action.

VICE CHAIRMAN SOLOMON. What does that $200 million difference mean in terms of the implied fed funds rate?

MR. AXILROD. Well, sometimes it means nothing. One of our rules of thumb has been 25 basis points per $100 million; another has been 20 basis points. They've all been wrong at various times. So, one could say somewhere between 40 and 50 basis points is represented merely by that. But, as the Chairman has said, misses in money supply are often much larger than this little range.

CHAIRMAN VOLCKER. What I think I am saying, in practice, is that we might set that path, depending upon where we start it, close to the "A" specification; we're probably not going to be very quick about making discretionary upward adjustments in the path if the shortfall is anywhere within the range of "A" to "C." We might consider one if it came in at 3 percent or less. It depends on what happens in M2 and all the rest, but that's what we're talking about.

MR. PARTEE. You have practically no room for discretionary upward adjustments in nonborrowed reserves because even under the circumstances you have cited--and remember we set a monthly average--if we're 3 points off, we're down to the frictional level of borrowing by the end of the period. So there is no room to have an upward--

CHAIRMAN VOLCKER. There's not a lot of room; that's right. And that's why we're talking about relatively small numbers here. We haven't got a lot of room unless we really wanted to push extremely hard. Precisely, we don't have much room.

MS. TEETERS. I'm not sure what you said. Did you say construct a path on "A" or--

CHAIRMAN VOLCKER. Well, that is one alternative one could take. But we would not be very quick about making discretionary adjustments. It depends upon where we start off or what people think about this. If we start off at $400 million and it fell to "B" or "C" or a little less, we're going to end up with $200 million. If it fell more sharply than that to well below "C," we're going to end up at a lower level and we may run into the federal funds rate constraint. That's what the operational decision is. Now, if we set it up the other way, it depends upon where we set the initial level of borrowing. In either case, I think we're saying that if it runs above, we don't do a thing--we accommodate it--which we've done often in the past.

MR. CORRIGAN. The way you stated it, isn't really the operative question how fast we want to get to that frictional level of borrowing? If we started with $400 million and a 6 percent path as distinct from $400 million and an 8 percent path, doesn't the operative question then reduce to how fast we want that borrowing level to get down to whatever that frictional level is?

CHAIRMAN VOLCKER. I think that's the operative question. And we're talking about a very narrow range.

VICE CHAIRMAN SOLOMON. So, the real policy issue is the one we discussed: Do we want a more rapid rate of decline in the early part, that is, in the next few weeks, or do we want to stretch it out and have a more moderated rate of decline? If we go for "A," we're taking a bigger risk that we will have the pressure earlier.

CHAIRMAN VOLCKER. It depends upon where we set the initial borrowing.

VICE CHAIRMAN SOLOMON. Well, I'm assuming the same range of $350 to $400 million. If you construct the nonborrowed reserve path on "A" rather than "C," then there's a greater risk that we'll get the downward pressure earlier and to a larger degree.

CHAIRMAN VOLCKER. It moves in that direction. We're talking about very small numbers in the next three or four weeks or so.

VICE CHAIRMAN SOLOMON. Yes. I accept that.

CHAIRMAN VOLCKER. The most important thing is where we set the initial borrowing.

MR. BOEHNE. And where the discount rate is.

CHAIRMAN VOLCKER. The discount rate will be an important consideration in where the market [goes]; in fact, that's going to be more important than this other thing. I'm afraid that the only two things that are going to make any real difference here, in the range that anybody is talking about, are if somebody says we want to go all out and make sure we're going to hit 7 percent M-1B growth and we ought to start with zero borrowings. Then we'd be talking about a very different kind of approach. But with the initial borrowing level someplace in the range that we're talking about, these other differences are going to be minuscule in a mechanical application of this [directive]. What is going to make the difference is if and how quickly the discount rate is changed and whether we make a discretionary adjustment as we go along.

MS. TEETERS. You wouldn't see the borrowings going above $400 million?

CHAIRMAN VOLCKER. I wouldn't see the borrowings going above $400 million under any conceivable conditions that I can imagine over the next five weeks.

MR. FORD. Unless you lower the discount rate by about 3 or 4 percentage points.

CHAIRMAN VOLCKER. Well, if we adopted a whole different kind of strategy, but barring a deliberate counter movement on the discount rate--

MS. TEETERS. You're assuming the discount rate will go down to around 12 percent during this period of time?

CHAIRMAN VOLCKER. I'm assuming that is quite possible. I will not make any premature assumptions.

MR. FORD. It depends on what [the Reserve Banks] recommend to [the Board].

CHAIRMAN VOLCKER. If we see both continuing weakness in business and continuing weakness in the aggregates, I think that would be a reasonable assumption.

MR. CORRIGAN. I would still argue that if we're going to get there, I'd rather get there in an orderly way. I would start off constructing the path off 6 percent with the borrowings at $400 million and if we have to adjust, we have to adjust. But I would want to get there in a deliberate, orderly way if we have to get there.

CHAIRMAN VOLCKER. What you're saying, "in a deliberate, orderly way" makes a difference of maybe $25 million in borrowings in the second week in December.

MR. CORRIGAN. I don't know. I'm not sure I agree with that.

CHAIRMAN VOLCKER. Is that wrong, Mr. Axilrod?

MR. CORRIGAN. My concern is getting into the realm of this frictional level of borrowings. I'm not sure I know what it means, but in my own mind's eye I have to leave room for the possibility that getting there could result in a situation where we would get a buildup in excess reserves and the federal funds market would really fall apart. That may be an outlier concern, but I have it.

MR. GRAMLEY. I share Jerry's views all the way. I could buy the idea of keeping a 7 percent path instead of a 6 percent path and putting in a contingency clause to the effect that an overrun would not be resisted in any way. But the idea of too disorderly a drop in interest rates at this point is the most important thing.

CHAIRMAN VOLCKER. I think you're focusing on the wrong thing. That's going to be more affected by the way we set the initial borrowing assumption than the mechanical thing that falls out of this.

MR. GRAMLEY. I agree.

CHAIRMAN VOLCKER. In a 4-week period.

MR. FORD. The appearance matter that Nancy mentioned is the one that keeps coming up in my mind. If this reads that we tightened the bands for the aggregates and we did not lower [the funds rate range]--we're at 12 to 17 percent now and you say we're going to go to 11-1/2 percent or stay at 12 percent, as a number of people have recommended--it's going to come off that the economy is crashing down and the Fed is cheering it on, possibly. Possibly.

CHAIRMAN VOLCKER. Where is [the bottom of the range] now, at 12 percent?

MR. STERNLIGHT. The range is 12 to 17 percent.

MR. FORD. The range is 12 to 17 percent and if you're saying we are not even going to lower the range--

MR. WALLICH. But the range really doesn't mean that it's being held there. It's a checkpoint for consultation.

MS. TEETERS. Only on the way up.

MR. PARTEE. It has worked extremely well. Well, I think maybe your point is a good one. Maybe we ought to start the initial borrowing a little higher for safety.

CHAIRMAN VOLCKER. Well, we're in a very narrow range here. I have a strong feeling within the narrow range that we've discussed here. All I'm trying to do is make the point that if we have to construct a reserve path, and that's what we're talking about, the difference between "A" and "C" at the extremes is not an immediate one; once we've set the original borrowing assumption, it can't change just mechanically by more than $25 or $50 million a week unless the money supply really falls out of bed. It would be changed because the money supply fell out of bed not because of the difference in the assumption; there's only going to be a $50 million difference in early December.

MR. PARTEE. That is something I want to guard against. It might not fall out of bed, but then it might fall out of bed.

CHAIRMAN VOLCKER. Oh, if it does, then the borrowing is going to come down. But it doesn't make any difference whether we pick "A," "B," or "C." If the money supply is negative, borrowings are going to go way down. That would be because the money supply went down, not because we picked "A," "B," or "C."

MR. BOEHNE. If we had borrowing at $400 million and then set the reserve path on 7 percent for October through December and had a funds range of, say, to 10 to 15 percent or even 11 percent to something, I think that would take care of the appearance problem in the directive as well as give us an approach on--

MR. PARTEE. But I do believe that it's probably when the funds rate breaks that we will really get the system to generate money. Because then the banks can't nicely lend their federal funds; they've got to get out there and do something else.

MR. BOEHNE. I think that kind of break comes below 10 or 11 percent.

MR. PARTEE. It would come with a break in the money supply, which would force these rates down.

VICE CHAIRMAN SOLOMON. Chuck, if we move in your direction to the 7 percent for October to December--I don't mean September, [but] October to December--would you accept a funds rate range of 11 to 16 percent?

MR. PARTEE. I don't want a top of 16 percent. I think that just looks absolutely ridiculous.

CHAIRMAN VOLCKER. I must say that looks a little foolish to me.

MR. PARTEE. I think then it would be a question of whether we want to narrow it to 11 to 15 percent. I might accept that. There are others who wouldn't. I think the biggest thing is--

VICE CHAIRMAN SOLOMON. Why do we have to keep the funds rate range at 5 points?

MR. PARTEE. Because we don't want it to seem constraining.

VICE CHAIRMAN SOLOMON. But everybody knows that the up side is academic anyway in the next five weeks. So, why couldn't it be 11 to 15 percent?

MR. FORD. Because then it will be perceived that in the last three meetings we've closed in on interest rate management. We would have gone from a 6-point spread to a 4-point spread and the charge will raised that we're managing interest rates.

MR. RICE. That's the way it's going to look.

MR. GRAMLEY. I could buy Ed's formulation of $400 million and 7 percent with a 10 to 15 percent federal funds range.

MR. PARTEE. I think maybe that's what we ought to settle on.

CHAIRMAN VOLCKER. Well, I have a feeling maybe we ought to go to lunch and settle it after lunch.

MR. SCHULTZ. Good idea. When in doubt, punt.

CHAIRMAN VOLCKER. Well, we'll have a quick lunch.

[Lunch break]

CHAIRMAN VOLCKER. Let me consider the numbers, with an undue degree of technicality, because we're in a very narrow band. I don't think there's much disagreement here on these details; whether they will work out or not is another question. Let me just get clear in my mind again what I asked you before. The difference, going all the way to the extreme, of something like an 8-1/2 percent growth rate and a 6 percent growth rate just in setting the reserve paths is going to be $2 billion, did you say?

MR. AXILROD. Yes. The difference is roughly $2 billion in December. So, if we set the reserve path on the highest [growth rate] and the lowest one turns out to be what actually happens, then the average level of borrowing--

CHAIRMAN VOLCKER. Well, don't make the lower one what actually happens. That's where we're setting the path theoretically now. We don't know what is going to happen yet. That's the next question I'll ask.

MR. AXILROD. All right.

CHAIRMAN VOLCKER. Your path would be $2 billion higher in December.

MR. PARTEE. With "A" than with "C"?

MR. AXILROD. The level of the money supply, M1-B, under "A" is put in at about $400 million higher in November than under "C." That's the question.

MR. PARTEE. And how about December?

CHAIRMAN VOLCKER. Well, is that because there's a bigger difference in--

MR. CORRIGAN. But on the reserve path, it's only different by $40 million.

MR. AXILROD. Well, the reserve path difference would be very small; it's not different by much.

CHAIRMAN VOLCKER. Well, why not? I don't understand that.

MR. WALLICH. Because it should be $1 billion.

MR. STERNLIGHT. The reserve path is relevant to just the 5 weeks. It's not quite the average for the month of December; it's the 5 weeks ending December 22 or whenever it is.

CHAIRMAN VOLCKER. I'm looking at the December part of the reserve path. The first period is not going to make any difference, because we're going to give you the level of borrowings. I'm not talking about what the money supply actually does now.

MR. AXILROD. Well, if you tell us the level of borrowing--

CHAIRMAN VOLCKER. Right.

MR. AXILROD. We will hold that level of borrowing through--

CHAIRMAN VOLCKER. Well, you'll hold the nonborrowed reserves that are consistent with it at the moment.

MR. AXILROD. That's right. And the difference in the amount of those two--

CHAIRMAN VOLCKER. It'll make no difference.

MR. AXILROD. Yes. But if you're asking about the difference in the amount of the nonborrowed reserve paths--

CHAIRMAN VOLCKER. That's what I'm asking--go ahead. That will only be different in December.

MR. AXILROD. I would say Jerry is right; it's roughly $40 million. You'd take the $400 million difference and divide it by 10 or something like that.

CHAIRMAN VOLCKER. Are you telling me the difference in the theoretical money supply--not the actual--for December between 6 percent and 8-1/2 percent is only $400 million in December?

MR. AXILROD. Well, no.

MR. WALLICH. It could be $800 million.

MR. AXILROD. By December the difference is $2 billion, much of which would affect reserves in January. So I'd need to make a very exact calculation here. If you just take the December $2 billion difference, that would be a $200 million difference in reserves, roughly. If you take the November difference, that's a difference of about $40 million in reserves, roughly. And the average for the 5-week interval between Committee meetings will be somewhere between that $40 million and $200 million on a nonborrowed reserve path, given borrowing.

CHAIRMAN VOLCKER. So, we're talking about a difference of only $200 million, which wouldn't really materialize all in December in choosing the path. Now the much bigger difference in the actual borrowing is going to be [because of] what actually happens to the money supply.

MR. AXILROD. That's right; that's how I started.

MS. TEETERS. Is your proposal that if the money supply comes in short we would lower the borrowing?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Well, that's what I am trying to see--how much room we've got for that.

MR. PARTEE. We stay on the nonborrowed path if growth comes in short, so borrowings go down.

MS. TEETERS. So borrowings fall off?

MR. CORRIGAN. That's the problem.

MR. AXILROD. Our staff projection, for what it's worth, is essentially alternative C. That is, we would expect money supply growth to come in at around 5 percent in November and 6 percent in December. It may be a little short of that.

CHAIRMAN VOLCKER. Unfortunately, with all due respect, that isn't worth much.

MR. AXILROD. Right. We think it will be that or a little less. So if you set the path at "A" and we were nearly right on "C," then borrowing by sometime in December would probably be a couple hundred million less than whatever borrowing number you choose, assuming nothing is done to raise nonborrowed reserves. That's one way of looking at it. But the error could be a lot bigger than that difference, one way or the other.

MR. GRAMLEY. $200 million is--

CHAIRMAN VOLCKER. Yes, that's the same $200 million I have here.

MR. AXILROD. Right, but it depends on where you start it.

MR. PARTEE. It has been two months or 6 weeks; it's come up.

MR. GRAMLEY. Yes, it's a lot of borrowing.

CHAIRMAN VOLCKER. Yes, but you're saying that's if it came in roughly around 5-1/2 percent. If it came in at 3 percent or something, that's another $200 million.

MR. AXILROD. Yes, then borrowing would be down to close to zero.

MR. SCHULTZ. That's where it begins to bother me.

MR. AXILROD. Then you'd be $400 million below path on total reserves.

CHAIRMAN VOLCKER. Well, I don't know how to avoid this. We'd just run into the federal funds rate constraint then. We have to consider what we want to do with any of these alternatives.

MR. GRAMLEY. Well, it seems to me the more we go for the reserve path under alternative A, the greater the likelihood that we're going to run into the frictional level of borrowings very soon. If you can agree with the staff's forecast that the actual money growth is more likely to be "C" than "A," and then you say to yourself that, if anything, we're more likely to come in below that than above it, you've really compounded the problem that I've been worrying about by selecting 8 or 8-1/2 as the money number on which we calculate the nonborrowed reserve path. Although it's true that it's only $40 million on average for the full month of November, it's going to accumulate to a lot more than that on an ongoing basis by the fifth week of this period. I think it gets to be a rather significant difference.

VICE CHAIRMAN SOLOMON. I do, too. The pressure we will get on rates will be significantly different if we have a shortfall. And that's what the real issue is about today.

MR. PARTEE. Yes, I think the question is: Should we have serious downward pressure on rates, if we have shortfalls--not only, as Lyle says, from 8-1/2 percent down to 5 percent, but below 5 percent or whatever it is? Shouldn't we be having serious downward pressure on rates because of the weakness that that implies for the economy?

VICE CHAIRMAN SOLOMON. The question is how far; that's the issue. If it drops another 225 basis points in the next 5 weeks from where it is presently, that's quite a substantial drop. If we go below--

MR. PARTEE. If you look at cyclical declines, it's not a very fast drop.

VICE CHAIRMAN SOLOMON. We're probably going to need more decline in January and February, too, beyond that though.

MR. PARTEE. The faster we get it down, the less distance it's going to have to travel.

MR. WALLICH. Well, very soon we'll have done as much as we did in 1980. We will have cut rates about in half. This would seem to be doing the same to the funds rate and bill rate.

MR. PARTEE. But I think Paul is right that we'd hit the funds rate constraint if we go through this frictional borrowing level, and we'd have a conference call as to what to do.

CHAIRMAN VOLCKER. I guess I can't convince myself that it makes all that much difference. Unless it made a real difference, even if the money supply was growing someplace in this range, we wouldn't want to see the federal funds rate drop any more.

MR. AXILROD. Mr. Chairman, I have an instinct--Mr. Sternlight may have a different one or may share it--that when we're talking about borrowings between $100 and $350 million, neither of us could argue that the funds rate would be--. At the low end there's a little greater odds that it will drop below the discount rate. At the high end there may be a little greater odds that occasionally it will be trading a point above the discount rate. But basically it would be around the discount rate, I think.

MR. WALLICH. Well, the risk is that it might drop very sharply below the discount rate, and in that case--

MR. AXILROD. But only if required reserves turn out to be a lot weaker than our nonborrowed path.

CHAIRMAN VOLCKER. But still, I don't think these differences make much difference in themselves. The question is: What happens if a real shortfall in the money supply is added on top of it? In that case we're going to run into [the need for] a consultation.

MR. AXILROD. In that case the lower the growth rate in money you start from, the less chance you have of being presented with that problem early, so to speak.

MR. GUFFEY. It seems most desirable.

MR. PARTEE. That's ignoring our policy responsibility not to have a consultation if we have great developing weakness in the economy. We don't want to avoid the problem; we want to precipitate it so we can talk about it.

VICE CHAIRMAN SOLOMON. Or we'll have our consultation earlier if we agree on an 11 percent floor rather than a 10 percent floor.

MR. PARTEE. That's true.

CHAIRMAN VOLCKER. I think that's probably the practical difference here. I take it that everybody is agreed that, whichever one of these numbers we put in, if the money supply came in higher in the short run, we wouldn't want to run up the borrowings, although it would be called for if we put in the low number. We'd have to override the thing, but I think that's understood.

MR. CORRIGAN. If we put the "somewhat higher" thing in there, that makes it explicit.

SPEAKER(?). Sure.

MS. TEETERS. Which higher thing?

MR. CORRIGAN. Regardless of what number we pick, if we put "____ percent or somewhat higher," it makes it explicit that we're not going to run up the borrowing if the money supply comes in stronger.

MR. SCHULTZ. What happens if we just take what we had last time, which is the 7 percent--leave it alone--and set the borrowings at $400 million and our consultation rate on fed funds at 11 percent?

MR. GRAMLEY. Do you mean 7 percent for October to December?

MR. SCHULTZ. No.

MS. TEETERS. November to December.

MR. PARTEE. He means September to December, doesn't he?

MR. GRAMLEY. September to December you calculate at 8 percent.

MR. SCHULTZ. No, November to December.

MR. PARTEE. Well, that's not the same as we had the last time. "A" is what we had last time.

MS. TEETERS. That's right.

MR. SCHULTZ. Yes.

CHAIRMAN VOLCKER. Well, that's the only thing. Of course, we can do that whatever we say in the directive.

VICE CHAIRMAN SOLOMON. Well, I would go with Fred's proposal. To me it's really important that we not repeat what we did last year. That's the one time I dissented and I'd have to dissent again, I think, if the fed funds floor were put so as to permit such a sharp drop in the funds rate over a short period of time.

MS. TEETERS. Don't forget that last year the economy went down at a real rate of 9-1/2 percent in the second quarter. No wonder the rates dropped so fast. We're going to have a decline here of about half that.

VICE CHAIRMAN SOLOMON. The reaction to that would be very perverse in the bond market. I'm convinced of it. And I think that is much more meaningful to an economic recovery.

CHAIRMAN VOLCKER. Well, the obvious in-between course is to draw the path just using the 7 percent. That leaves it between the 8-1/2 and 6. Something around 7 or 7-1/2 percent splits the difference; it sounds all right to me. If the money supply really goes off on the down side, we're going to have a consultation anyway. I think that's quite evident.

MS. TEETERS. What are you doing? Are you suggesting "B" with a quarter billion dollars of original borrowing?

CHAIRMAN VOLCKER. I don't think in terms of "Bs" or whatever here.

MR. PARTEE. Well, communicate.

MR. WALLICH. Set the borrowing requirement high to be safe. Set the path, however, so we get some addition to reserves during the period and some downward pressure on rates.

CHAIRMAN VOLCKER. That's what we're talking about.

MR. SCHULTZ. One might term my proposal "a son of a B," I guess.

CHAIRMAN VOLCKER. We're talking about $400 million, which I wouldn't want to exceed in the short run and, say, 7 percent just for purposes of drawing the path. That's all we have to do at the moment. Then we've got to write a directive which encompasses this. And we still have the choice of whether to put in a low figure and say "or higher," or to put in a high figure. I tried to rewrite the one starting with the high figure. I had some bias, I must confess, toward not changing the directive, which we can't meet anyway every month. But let me try this wording on you: "After reviewing the quarterly targets for M1-B from September to December at an annual rate of 7 percent (after allowing for NOW accounts) and for M2 at an annual rate of about 10 percent or slightly higher..." And we probably should put a phrase in there "adopted at the last meeting" or something. "...the Committee decided some shortfall in M1-B, generally consistent with phasing into the tentative money growth targets set for 1982, would be acceptable in a context of declining interest rates and continued strength of M3."

MS. TEETERS. M2.

CHAIRMAN VOLCKER. M2 rather, yes. I don't know; this seems fairly plain to me.

MR. GRAMLEY. Well, I don't know how that relates to what we've been talking about.

CHAIRMAN VOLCKER. Well, it relates to what we were talking about just now.

MR. FORD. Is that the end of it, Paul?

MR. PARTEE. It couldn't be.

CHAIRMAN VOLCKER. Well, it goes on and gives the federal funds range, but that's--

MR. WINN. What's that going to say?

MR. STERNLIGHT. 7 percent in November and December?

CHAIRMAN VOLCKER. It's the same language; we've got to fill in the blanks. I take it we have a split between 11 to 15 percent and 10 to 15 percent, right?

MS. TEETERS. I would much prefer the 10 to 15.

CHAIRMAN VOLCKER. All right. My feeling in substance is that we ought to consult at 11 percent, but I--

MR. FORD. I don't think we should do this now. With a range of 6, then 5, and then 4 points, we're going to be charged with coming every time closer and closer to managing interest rates. Whether or not they perceive it correctly, that's what is going to be said.

CHAIRMAN VOLCKER. I don't consider that entirely a bad idea.

MR. FORD. If that's what you want.

SPEAKER(?). Fred, did you hear that?

MR. WALLICH. Why do we need to specify? One sort of inference [about] interest rates here is the borrowing assumption. The Chairman may consult the Committee, so the funds rate constraint isn't even a binding action.

CHAIRMAN VOLCKER. What is the substance of your comment?

MR. WALLICH. I'm wondering why we need to expose ourselves to the charge that we're managing interest rates when we're not doing that?

MR. PARTEE. Do you mean just take out the funds rate reference?

CHAIRMAN VOLCKER. Take out the whole sentence?

MR. WALLICH. Take out the whole sentence.

VICE CHAIRMAN SOLOMON. That's certainly widening it!

MS. TEETERS. Yes.

VICE CHAIRMAN SOLOMON. Nobody is really going to believe that we're indifferent.

CHAIRMAN VOLCKER. I don't know what people would conclude from our taking out the sentence entirely at this point.

MR. BLACK. They'd never get it from Henry.

MR. MORRIS. That we've gone completely monetarist?

CHAIRMAN VOLCKER. I think for sure, at this point.

MR. PARTEE. What is it, 75 percent of--

MR. MORRIS. Milton Friedman has finally won!

MR. FORD. Let's try it and see what happens!

MS. TEETERS. I still don't like the phrase about phasing into next year.

CHAIRMAN VOLCKER. Well, I don't think that is essential, but I don't know how other people feel about it. It gives some feeling of the dimension of what we're talking about.

MR. KEEHN. To restrain ourselves this late in the year without putting that comment in about leading us into next year would be bad. I'd be very much in favor of including those words.

MS. TEETERS. My problem is that [money growth rates] are coming in so low this year that if we start talking about lower targets next year--there's already talk around the market of our being lower-limit monetarists--it gives the impression that we're heading for the lower limit next year as well.

MR. KEEHN. Well, as I said earlier, it seems to me that the direction we're going will tend to put us toward that range. We can phrase it in a way that we are aiming toward that range, not necessarily that we'll fall under it.

MS. TEETERS. Well, we're already under for this year.

VICE CHAIRMAN SOLOMON. Yes, but the language doesn't--

MR. KEEHN. The language doesn't say that.

MR. RICE. Well, we're going to be.

VICE CHAIRMAN SOLOMON. [Unintelligible] then we would have a shortfall. [Unintelligible] the language--

MS. TEETERS. It sounds as if we're trying to pull [money] down so we can make next year's target, and we're already below where we want to be next year--or where you guys want to be next year.

MR. PARTEE. Well, we have the very real question of what to do about this year's shortfall--whether to add it to next year's range or not. We haven't discussed that.

MR. WALLICH. If we move to plain M1, then we're back to the unadjusted and that's right in the middle of the range. So, we'd start right from there.

MR. FORD. We can do a definition shift.

MR. WALLICH. We got rid of the base drift.

MR. SCHULTZ. We got rid of the base drift.

SPEAKER(?). Somebody said there is a definition shift.

[Secretary's note: Mr. Guffey was leaving the room.]

CHAIRMAN VOLCKER. [To Mr. Guffey] Are you going to vote?

MR. GUFFEY. No. I don't have a vote or I would stay.

CHAIRMAN VOLCKER. Are we having a vote?

MR. FORD. Instead of base drift, we're going to use definition shift.

CHAIRMAN VOLCKER. Well, I don't think we can argue out next year's targets here. We have a wide enough range [of views] to start with. All this is meant to convey is that we're recognizing that 7 percent is high and we wouldn't mind being a little lower. That's what we're saying.

MR. GRAMLEY. Well, I don't understand why we want to deviate so drastically from the kind of operational directive we typically set up. In effect, we're using language that doesn't have any meaning to me. And I don't know how it will have any meaning for somebody on the outside. Why [don't] we go along the lines of what Fred was suggesting of specifying for the directive that we're seeking M1-B growth of 7 percent between October and December?

MR. PARTEE. Or somewhat higher.

MR. GRAMLEY. Or somewhat higher.

MR. PARTEE. That makes it seem quite consistent.

MR. GRAMLEY. Then we know what we're talking about

CHAIRMAN VOLCKER. Well, I don't think you're going to get agreement on that. I'm allergic to [unintelligible] down every meeting, if I may say so, some target for the next 5 weeks that has nothing to do with [unintelligible]. It's just the law of distribution; we don't come very close to it, whether we're above or below it. I'd like to relate the actions in one meeting to the actions of the previous meeting. It's just presentational. We did that, I guess, last time. I forget what we did last time in substance, but it was some kind of reiteration of the target at the beginning of the quarter.

MR. BOEHNE. Well, there may not be agreement around the table, but I like what Lyle and Fred are suggesting for the directive.

CHAIRMAN VOLCKER. I don't know what "7 percent or higher" means. If we get a shortfall, what do we do then? Does that imply real aggressiveness? It sounds like it to me. You're saying now that we're starting out there; I don't think the staff projection is worth much, but I think the probabilities are we could well be below 7 percent. Then we'd better be very aggressive.

VICE CHAIRMAN SOLOMON. I thought it was going to be "7 percent or lower."

MR. BOEHNE. Say 7 percent--

MR. SCHULTZ. Well, if we said "7 percent or somewhat lower," what does that do for you?

MR. WALLICH. Then do we accept it if gets higher?

CHAIRMAN VOLCKER. That's the problem: Do we accept it if gets higher?

MR. WALLICH. I can see myself accepting if it gets higher, but I wouldn't want to set the few steering mechanisms we have to accomplish that.

VICE CHAIRMAN SOLOMON. It's highly unlikely it would be higher.

MR. PARTEE. Well, it could happen.

CHAIRMAN VOLCKER. Who knows in this world? But I think we have to have agreement that if it's higher, we don't want to do anything.

MR. GRAMLEY. That's the one thing I can agree with.

CHAIRMAN VOLCKER. And I thought we had some agreement that if it's lower, we don't want to be all that aggressive either.

MR. GRAMLEY. I certainly can go along with that.

MR. PARTEE. I don't know; it depends on how much lower.

MS. TEETERS. Isn't there agreement to let the borrowings slide if it begins to come in low?

CHAIRMAN VOLCKER. Yes. I said "not all that aggressive." We'd let them slide as they would naturally slide.

MS. TEETERS. But the question is on what path to construct M1-B, isn't it--whether it's 7 or 8 percent in the quarter?

CHAIRMAN VOLCKER. Tentatively, I thought we'd arrived at constructing the path on 7 percent.

MR. WALLICH. Well, if we start with a sufficiently high borrowing assumption, I could go with that.

CHAIRMAN VOLCKER. No, we're talking about $400 million, as I take it.

MR. PARTEE. That's surely high; that's the borrowing associated with "C" in the Bluebook.

VICE CHAIRMAN SOLOMON. The problem is that if we don't use the 7 percent number, we then get into the formulation--if we don't want to change it in the middle of the quarter--in which the wording is so fuzzy that nobody really knows what it means. If we want to follow a policy of not changing target numbers during each quarter, that would have to become, I think, a consistent policy.

CHAIRMAN VOLCKER. Well, if we had a strong reason for wanting to change it, we would change it, obviously. But I think what people are saying here is that if we met that original target, everybody would be happy.

MR. CORRIGAN. What if we took your language there--I'm not sure I have it right--and got rid of the business about the generally declining interest rates and next year's targets, and just had the initial reference to 7 percent growth for the quarter. We could put in a phrase that said the Committee sought growth in the monetary aggregates consistent with the 7 percent, taking account of the shortfall in October, and said nothing else.

CHAIRMAN VOLCKER. I don't know what that means.

MR. PARTEE. I think that means we'd make up for it.

MR. CORRIGAN. Well, it means we could go ahead and construct a path--

MR. AXILROD. [The staff will] construct the path on whatever the Committee tells us.

MR. CORRIGAN. I was trying to get around the problem some people have with declining interest rates and next year's targets.

MR. PARTEE. Well, we could do it by saying "forgetting the shortfall in October."

MR. GRAMLEY. We could say "while noting the shortfall in October."

CHAIRMAN VOLCKER. We can say "The Committee decided in the light of the shortfall in October to accept a lower rate for the quarter." That we can say.

MS. TEETERS. But affirm the target for the last two months.

MR. PARTEE. Yes, I think that's what we're doing. We're accepting the shortfall and saying: Let's get it back on 7 percent from now on, if we reasonably can.

CHAIRMAN VOLCKER. We have several precedents for saying we accept this kind of thing in a context of declining interest rates, or the reverse, don't we?

MR. AXILROD. Yes, there were a couple of instances of that that I have found.

MR. CORRIGAN. Yes, one each way.

MR. AXILROD. It was back in December '80, but that followed a period of rapid growth.

MR. CORRIGAN. Didn't we have something like that in the directive in April or May of last year, Steve?

MR. AXILROD. Yes, in May there was a shortfall from the 2-month rate specified, and it was accepted in the light of the rapid growth in April. They all followed rapid growth; that's the problem. They didn't follow slow growth. In August, Mr. Chairman, following the slow growth in July, the Committee just reaffirmed the third-quarter target of 7 percent.

MR. STERNLIGHT. We were expecting at that point a pretty hefty growth in August, like 11 percent.

MR. AXILROD. Yes, that's right.

MR. CORRIGAN. And we weren't faced with zero borrowings.

CHAIRMAN VOLCKER. Well, I have arrived at wording that says: "The Committee decided in the light of the low rate of growth in October of M1-B, that some shortfall in the growth of M1-B from the target for the quarter would be acceptable, in a context of declining interest rates and continued strength in M2." That should be worded, I think, in a conditional way. If M2 is--

MR. GRAMLEY. You're going to drive the monetarists up the wall with that. In the context of a weakening economy and declining interest rates, we'll accept shortfalls from our targets.

CHAIRMAN VOLCKER. That's in substance what you want to do.

MR. GRAMLEY. I know. I'm not a monetarist. I was just thinking about those sensitive ears out there.

MR. WALLICH. Why can't we just say "After taking note of the movements of the aggregates," with no specification as to what they were, "the Committee decided..."

CHAIRMAN VOLCKER. What?

MR. WALLICH. You have to decide.

CHAIRMAN VOLCKER. Oh, I think that's what we're going to decide.

MR. WALLICH. But you're saying here "after noting the shortfall" or "after accepting a shortfall." I don't think we need to say that.

VICE CHAIRMAN SOLOMON. I think the lesser evil is to put the 7 percent number down and not worry about the fact that we're changing.

MR. BLACK. The only alternative is to put a short-term range in and I don't want to suggest that.

MS. TEETERS. It's easier to say 7 percent for the last two months.

MR. AXILROD. Mr. Chairman, if I may say so, in response to President Solomon's comment: I'm not an expert on public relations but the Committee had put down a third-quarter number of 7 percent; it was missed and I think it was understood. For the fourth quarter a number of 7 percent also was put down, which will probably be missed and probably will be understood. But if the Committee then decides to put down a November-December number that is also 7 percent, people are going to wonder after you've missed that one. This would be your third try.

CHAIRMAN VOLCKER. That is partly what bothers me.

MR. FORD. We're becoming predictable.

CHAIRMAN VOLCKER. We keep promising these short-term results that we don't get. That is precisely what bothers me.

MR. FORD. The market can adjust it to that point, so long as we stay consistent.

MR. KEEHN. It seems to me there's a real risk in putting out a [number in the] directive that we know we can't achieve. Apparently we're far enough through the period that the opportunity of having the 7 percent come in is very remote. If that's the case, are we better off using a number which is more achievable and gives us more credibility?

CHAIRMAN VOLCKER. We're not that far off in the sense that we'll probably hit the M2 target. And what we're saying in this formulation is that we agree we will probably miss on M1. That is the purpose of this [wording].

VICE CHAIRMAN SOLOMON. What is your projection for now, Steve, 5 percent?

MR. AXILROD. Alternative C is essentially our projection, or we think it will come in a little lower. That's why we bent the wording that way.

VICE CHAIRMAN SOLOMON. Well, what we're trying to do is structure a compromise, Si. We're most likely to hit alternative C or below, but that's not acceptable to a substantial number of people, Chuck and others. So we've been trying to grope for a compromise in that area. If we go back to your kind of language, even though it's confusing to the public, we'd still have to have a private understanding on how much shortfall--

CHAIRMAN VOLCKER. Well, there isn't any what you call private understanding. Yes, we have to set a reserve path, which we've just tentatively set; there's no obscurity about it. The way to avoid these things in the future--but it would get us into other problems--is to say we're setting the reserve path at X, which we consider consistent with 7 percent. We are not promising we're going to make 7 percent; that's just where we're setting the reserve path.

MR. SCHULTZ. What is the great difficulty with using 7 percent--and that sets the reserve path--and then using the borrowing assumption and the fed funds constraint to take care of the fact that we are going to miss that one way or the other?

CHAIRMAN VOLCKER. That's what we're trying to do, as I understand it. I think we have agreement on the substance; it's just how to describe it.

MR. SCHULTZ. My problem is my simple mind; I don't have any difficulty with what I just said. But maybe others do.

CHAIRMAN VOLCKER. Do you think you can give language for a directive, if I understood you correctly?

MR. SCHULTZ. I just would use the number 7 percent in a straightforward directive--the normal kind that we have used before. I'd use the numbers for M1-B and M2 that are under alternative B, which are 7 percent and 11 percent or something like that. And then I'd put in a fed funds constraint, which I would prefer at 11 percent because it's very difficult to know what is going to transpire in this very short period of time and I think it's worthwhile to confer at 11 percent. I'd start with a borrowing assumption of $400 million, recognizing that there is every likelihood that it will come down and none that it would go up because we would be generally tolerant of some additional strength in the aggregates, which none of us feels is going to happen.

MS. TEETERS. What about the language you had a minute ago that we would provide reserves in the two-month period that would be consistent with a 7 percent rate of growth in the money supply? Shift it from a pinpoint to a reserve supply in there.

CHAIRMAN VOLCKER. That's just the traditional form.

MS. TEETERS. And say we're going to hit the money supply at 7 percent, but--

CHAIRMAN VOLCKER. This is the wording we have--that we provide reserves consistent with the 7 percent. This says "behavior of reserve aggregates." We can do it just by putting in those numbers. That's right. And every month we're putting in numbers that we aren't going to make. We can do that; that's simple enough. But I don't think it conveys any more information.

MR. SCHULTZ. A number has two purposes. One is a target; then there is a number which is used to construct a nonborrowed reserves path. So, it has two functions. And it seems to me that even if we really don't think conditions are such that we will make it as a target, it is useful in setting the path.

CHAIRMAN VOLCKER. There's no question. The more I look at this, the more I think we're arguing over nothing. We act as if the only thing people read is this paragraph. Whatever we say we're going to have to describe in the rest of the policy record, and we're presumably going to describe it in more or less similar terms.

MR. PARTEE. How about something like "While taking note of the moderate shortfall in growth of the aggregates during October"--and it was only a moderate shortfall--"the Committee continues to seek expansion at the rate of about 7 percent in M1-B and 10-1/2 percent in M2 in the period ahead." And that says we gave up October.

MR. MORRIS. While noting it and ignoring it.

MR. PARTEE. Yes, taking note, we continue to seek--

MS. TEETERS. Don't you have M2 growth too low?

MR. PARTEE. I didn't have the Bluebook open right there. I think 10-1/2 percent is about--

MS. TEETERS. 11-1/4 percent is--

MR. CORRIGAN. I didn't say it very well, Governor Partee, but that's the gist of what I was trying to say before.

MR. GRAMLEY. We'd have to drop out the language "seeks behavior of reserve aggregates." Or maybe we wouldn't.

CHAIRMAN VOLCKER. It's the traditional way of doing it. I don't think it makes any difference in substance; we'll describe it all anyway [in the policy record]. But it gives you less information and we're still back to this business about jumping up and down every time we have a 2-month target or a 5- or 6-week target over which we don't have much control. But if you can rationalize it and say that's where the reserve path--

MR. WALLICH. How about "set the reserve path designed to achieve X percent growth"?

CHAIRMAN VOLCKER. Well, that's what we say ordinarily. That's the traditional form.

MR. PARTEE. I really don't think this is a good month to try to reform the way we state the directive. It's in the middle of a quarter, as you said before; it's at the end of a year; and it's in a period where we're going to fall short of our growth for the year as a whole. And we just shouldn't be doing fancy things with the directive right now. If we want to do it, we can do it in January and start out a new year with a--

CHAIRMAN VOLCKER. But we don't have this kind of problem in January--at the December meeting--because we're starting a new period for which we have no targets. So, we don't have the problem.

MR. BALLES. Does anybody recall how we handled this a year ago when we went through some gyrations in order to get the monetary growth rates cranked down so that--

CHAIRMAN VOLCKER. I don't think we presented a quarterly target a year ago.

MR. PARTEE. I don't think so either.

CHAIRMAN VOLCKER. The difference now is that we have put these things on a quarterly basis, and we did that with a purpose in mind--maybe it was only in my mind--which was to be a little consistent over the quarter. The concept was for the meeting in the middle of the quarter to review the target we already set for the quarter. Now, this is a kind of reversion to taking a look at it--

MS. TEETERS. I like Chuck's language. Governor Partee's language finesses all of our problems and we've had enough discussion here, I think, that the Manager will know what it is we're trying to achieve.

MR. PARTEE. We could be more specific as to the time period by saying "for the remainder of the year" instead of "in the period ahead."

SPEAKER(?). That is five weeks?

MR. SCHULTZ. No, it's almost seven.

MR. PARTEE. It's essentially November and December.

CHAIRMAN VOLCKER. Well, I don't think we're arguing about any substance. As a matter of form, I don't like it. But if everybody else likes it--

MS. TEETERS. What's the funds rate formulation, Chuck?

MR. PARTEE. Oh, I didn't specify that. We were just talking about directive language. The specs the Chairman will recommend to us, I'm sure.

CHAIRMAN VOLCKER. Well, on that, I would prefer the 11 to 15 percent just to get a consultation at around 11 percent. If we were absolutely symmetrical around where we now are, we'd make it 10-1/2 to 15-1/2 percent, I guess.

MR. GRAMLEY. It gives us a little breathing room.

MR. BOEHNE. Why don't we make it 10 to 16, Schultz? Better yet.

MR. GRAMLEY. It's the bottom end--

MR. PARTEE. 16 percent, ha, ha, ha.

MS. TEETERS. It's only been a month since it was there.

MR. PARTEE. A lot has happened in a month.

CHAIRMAN VOLCKER. I don't see how anybody can take any offense at 10-1/2 to 15-1/2 percent. That is absolutely the traditional--I'm talking about the outside reader. A Committee member can, maybe.

MR. PARTEE. That centers it on 13 percent.

CHAIRMAN VOLCKER. It's centered on where we are, which is what we've been doing.

MR. WALLICH. Well, then it is, what--2-1/2 points below the discount rate? That must mean that there's practically only frictional borrowing.

MR. AXILROD. It's not lower than where the discount rate is.
MR. WALLICH. Then it's very unstable already.

MR. FORD. Yes, Henry, but we'll send you a recommendation on the discount rate.

MR. BALLES. I've already sent one.

MR. WALLICH. That's something one would like to be able to decide while not under the pressure of a collapsing funds rate.

CHAIRMAN VOLCKER. Yes, but that goes to the reserve path, I think, not to--. Well, one can argue that we might want to consult at a higher rate. I'd just as soon consult at a higher rate myself. But I don't think where we put this number is going to affect where the funds rate goes; it affects where we consult.

MR. WALLICH. Well, that's what I had in mind.

MR. SCHULTZ. Well, we never consult unless that bottom level is broken. We never consult just because it drops and touches the number and pops back up. I tell you: The funds rate is a little over 13 percent now, and if we're breaking 11 percent in a 5-week period, that's really moving down.

MS. TEETERS. We've had informal agreements before to consult before we hit the bottom or the top of the range. We could do that this time also.

MR. WALLICH. We certainly shouldn't wait a week and establish the average that begins breaking the lower level.

CHAIRMAN VOLCKER. I am sensitive to your point, but we still have to put some number in here. In fact, we may consult before we get to that number. That's always an option. We can consult any time we want to consult.

MR. BLACK. And you can control that.

CHAIRMAN VOLCKER. I have a certain amount of control over that.

MR. WALLICH. Well, do you feel constrained from consulting before we reach that point?

CHAIRMAN VOLCKER. No. Not for that reason alone. I only feel constrained in the sense of wanting to consult if there were genuine confusion over what we should do, whatever these numbers are.

MS. TEETERS. If we had an M1-B target of 7 percent for November-December, an M2 target of 11-1/2 or 11-3/4 percent, the funds range of 10-1/2 to 15-1/2 percent, and initial borrowings at $400 million, does that cover what we've been [unintelligible]?

CHAIRMAN VOLCKER. Well, I am not in favor of that formulation. But if everybody else loves that formulation--

MR. CORRIGAN. What was that first alternate directive language you had earlier in the meeting about five hours ago? The one that we didn't have [in front of us].

VICE CHAIRMAN SOLOMON. It said the Committee had set aside--

CHAIRMAN VOLCKER. It was essentially this, just a straightforward--

MR. CORRIGAN. No. There was some nuance in there that allowed you to keep the 7 percent quarterly number.

MR. AXILROD. I think it was "a somewhat higher growth rate would be acceptable and would be consistent with the quarterly targets previously [adopted]."

CHAIRMAN VOLCKER. It puts in the "higher." It says the lower one won't be acceptable at 7 percent.

MR. AXILROD. Yes. It had a second sentence that it could be higher if it was consistent with the quarterly targets or something like that--

MR. CORRIGAN. But isn't the presumption clear enough there that if it's lower, we would respond the same way?

CHAIRMAN VOLCKER. I don't think so, but that's why I'm not crazy about it. This one only had 10-1/2 percent for M2 as Mr. Axilrod wrote it.

MS. TEETERS. But is 10-1/2 percent on M2 consistent with 7 percent on M1, Steve?

MR. AXILROD. Well, for the quarter, we thought it would be a little higher than 10-1/2 percent; it could be 11 percent. But the Committee's decision was 10 percent or a little higher last time.

MS. TEETERS. For the quarter.

MR. AXILROD. For the quarter. So, it's not inconsistent with that at all.

MR. SCHULTZ. We might go with a straight crap shoot and call it 7 and 11.

MR. PARTEE. That's what I have: 7 percent for M1-B and 11 percent for M2 for the remainder of the year.

CHAIRMAN VOLCKER. Well, let's settle this federal funds range. All these cosmetics don't amount to a hill of beans in some way, since we explain it all in the [policy record]. Who wants to put the bottom at 11 percent?

MR. GRAMLEY. The fed funds rate?

CHAIRMAN VOLCKER. The bottom of the fed funds range. Well, we have a majority there, clearly.

MR. PARTEE. How am I going to [contend] with having a consultation at 11 percent? Usually I'm against that kind of thing.

MR. CORRIGAN. Why don't you ask who will accept 10-1/2?

CHAIRMAN VOLCKER. Well, the alternative is 10-1/2 percent. Big deal! How many would prefer 10-1/2?

MR. PARTEE. I would prefer it.

MS. TEETERS. Why not 10-1/2 percent with a consultation at 11 percent?

MR. BOEHNE. I like Chuck's: Consult at 11 percent; 7 percent [for M-1B]; and 10 percent [for M2].

CHAIRMAN VOLCKER. The only problem I see with 11 percent, which I prefer in fact on the lower end, is where to put the top. A 16 percent figure looks a little ridiculous to me.

SPEAKER(?). You've got it!

MS. TEETERS. We can consult at 11; it's the same thing.

MR. GRAMLEY. To maintain our credibility in fighting against inflation at 16 percent.

\ CHAIRMAN VOLCKER. How about 11 to 15 percent?

MR. WALLICH. How about 11 to 16 and consult at 15?

MR. SCHULTZ. But, Henry, that's symmetrical. You don't want to be that--

MR. WALLICH. Sometimes we can afford to be symmetrical.

CHAIRMAN VOLCKER. An 11 to 15 percent range happens to be completely symmetrical around the present level of 13.

VICE CHAIRMAN SOLOMON. Do you want a show of hands?

CHAIRMAN VOLCKER. Yes. Is that acceptable?

MR. PARTEE. Acceptable is what you want?

CHAIRMAN VOLCKER. Acceptable at this point. All right. Now, I take it there's agreement that we're going to set a path on the 7 percent and we probably won't be moving that discretionarily downwards very readily because we haven't much room to do so. If it comes in weak, it will go down by itself starting at a borrowing level of around $400 million. I think that's where we've been. So, the only thing that remains is that we can just use this traditional format and say 7 percent for M1 and whatever we say for M2.

MR. SCHULTZ. 11 percent.

CHAIRMAN VOLCKER. 11 percent.

MR. KEEHN. Well, when we say 7 percent, is it going to be the wording that's here of September to December?

MS. TEETERS. October to December.

MR. KEEHN. Or November and December.

CHAIRMAN VOLCKER. We can put the phrase that Chuck had in front of it: "The Committee noted the shortfall."

MR. PARTEE. The moderate shortfall. It's the only month when we had just a moderate shortfall.

MR. KEEHN. Yes, but I think we talked about November and December.

MR. PARTEE. Say "for the remainder of the year" so that we don't have to say November to December.

MR. WALLICH. Did we overshoot on M3?

MR. PARTEE. We don't specify M3.

MR. BLACK. Don't forget bank credit.

MR. WALLICH. A higher aggregate.

CHAIRMAN VOLCKER. "The Committee, after noting a moderate shortfall in M1"? Yes, but turn it around.

VICE CHAIRMAN SOLOMON. I'd say "a symmetrically moderate shortfall in M1 and an overrun in M2."

CHAIRMAN VOLCKER. No, we didn't have an overrun in M2.

MR. PARTEE. No, we didn't. We expected 12.9 percent.

CHAIRMAN VOLCKER. Well, the directive said 10 percent for the quarter.

MR. GRAMLEY. In the earlier part, in the general paragraphs of the directive, there needs to be some reference to the elimination of the surcharge. You have a sentence here which is "On October 30 the Board of Governors announced a reduction in the Federal Reserve basic discount rate from 14 to 13 percent." I would think we'd also want to add that "on November 16 the Board announced the elimination of the surcharge."

CHAIRMAN VOLCKER. I'm glad somebody reads that!

MR. AXILROD. Mr. Chairman, without raising any further problems for the Committee, with Governor Partee's addition of "after noting the shortfall" does the Committee want to say after the 7 percent "or somewhat more"?

CHAIRMAN VOLCKER. No. I don't think so.

MR. PARTEE. I just said "about."

MR. WALLICH. When we say "somewhat more," does that mean we freeze the funds rate at that level?

CHAIRMAN VOLCKER. I don't think we want to say "somewhat more" especially because of what happens if it's somewhat less.

MS. TEETERS. Why can't we say "about"?

MR. PARTEE. Yes, I said "about" 7 and 11 percent. "Around" is all right.

VICE CHAIRMAN SOLOMON. This directive will get known as the 7 to 11.

CHAIRMAN VOLCKER. What the directive will say is: The Committee, after noting a moderate shortfall in growth in M1-B in October from the target path set at the last meeting,..."

MR. WALLICH. And the continued high level of M2.

CHAIRMAN VOLCKER. "... seeks behavior of reserve aggregates consistent with growth of M1-B from October to December at an annual rate of 7 percent (after allowance for...Now accounts) and with growth in M2 at an annual rate of around 11 percent." And we're at 11 to 15 percent on the federal funds range.

MR. WALLICH. I think we're making it needlessly difficult by pointing to M2 as the balancing item that keeps us where we are. Why don't we just play down M2 in this?

CHAIRMAN VOLCKER. This is just the way it was the last time. They get equal weight.

MR. WALLICH. Yes, but now we've mentioned the shortfall in one and said nothing about the other except--

CHAIRMAN VOLCKER. The other was within the target.

MR. PARTEE. We were expecting apparently a higher October number than we got by a couple of points.

CHAIRMAN VOLCKER. We were expecting a higher number than what we got and we were 0.7 below the figure we mentioned in the directive.

MR. PARTEE. It was surprising, considering all savers certificates.

MR. SCHULTZ. Let's vote.

CHAIRMAN VOLCKER. I'm in favor of that.

MR. GRAMLEY. Mr. Altmann called to my attention that we have had more than one change in the surcharge since the last meeting. We'd have to do more than put in this suggested elimination, so I withdraw my suggestion.

CHAIRMAN VOLCKER. So, there's no mention of a surcharge?

MS. TEETERS. Why don't we put both of them in there?

CHAIRMAN VOLCKER. I think we can delegate to the Secretary to put in a mention of the surcharge in the appropriate place.

MR. PARTEE. How about "eliminated it in two stages."

MR. KEEHN. Are you dropping from the directive the comments about next year?

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. Except to the extent that they're in that paragraph that indicates the preliminary specifications.

MS. TEETERS. Yes, it does--

CHAIRMAN VOLCKER. Now that we have labored over this thing that nobody is going to see for six weeks and until it's no longer relevant any more--

MR. SCHULTZ. And will be known as the Federal Reserve crap shoot when it comes out.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Keehn	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	Yes

VICE CHAIRMAN SOLOMON. Is this the first meeting with no dissent this year?

END OF MEETING